THE VALUE OF SOFT VARIABLES IN CORPORATE REORGANIZATIONS

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When a company is worth more as a going concern than on a liquidation basis, what creates that additional value? Is it the people, management decisions, the simple synergies of the operating business, or some combination of these types of soft variables? Perhaps more importantly, who owns or has an interest in these soft variables? This Article explores these questions under existing legal doctrine and practice norms. Specifically, it discusses the characterization of soft variables under applicable law and in financing documents, and it surveys related judicial decisions. It also considers the overarching public policy and Constitutional implications of the treatment of soft variables in and outside of the federal bankruptcy scheme. The Article concludes by considering the optimal treatment of soft variables in corporate reorganizations.

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I. INTRODUCTION

Consider an airline: it typically owns or leases aircraft, spare parts, flight simulators and training equipment, ground support equipment, gate space at airports, and proprietary software.[1] These assets standing alone hold independent but limited value. Together, their value is potentially greater but something more must be added to the equation. This something more—a corporate *je ne sais quoi*—enhances the value of the collective assets and distinguishes the company from its competitors. It is what makes the company's whole worth more than the sum of its parts.[2]

In the airline industry, Southwest Airlines is a notable example. Southwest's management historically has made sound strategic decisions in the company's hedging strategy and pricing model.[3] Management also has sought to capitalize on what it calls the company's most valuable asset: its people. "As our greatest asset, our People create a FUN travel

1. *See generally* Agis Salpukas, *Looking for Value in Airline Assets*, N.Y. TIMES, Sept. 1, 1989, http://www.nytimes.com/1989/09/01/business/market-place-looking-for-value-in-airline-assets.html (discussing AMR's restructuring options at the time, including the sale of its aircraft).

2. Notably, the going concern value (or value of the company as a whole) may not always be worth more than the sum of its parts. *See, e.g.*, Paul Ausick, *Blackberry: The Whole Worth Less than the Sum of Its Parts,* YAHOO FINANCE (Oct. 10, 2013, 8:40 PM), http://finance.yahoo.com/news/blackberry-whole-worth-less-sum-124017277.html (discussing this valuation proposition in the context of Blackberry Ltd.'s financial and operational distress). When that is the case, soft variables discussed in this article may not be present, and a piecemeal liquidation—as opposed to a going concern sale or reorganization—likely is warranted. *See* discussion *infra* Part V.

3. *See, e.g.*, PETER NAVARRO, THE WELL-TIMED STRATEGY: MANAGING THE BUSINESS CYCLE FOR COMPETITIVE ADVANTAGE 134–35 (2006) (discussing Southwest's fuel hedging strategy in the early 2000s); Jeff Bailey, *Southwest Airlines Gains Advantage by Hedging on Long-Term Oil Contracts*, N.Y. TIMES, Nov. 28, 2007, http://www.nytimes.com/2007/11/28/business/worldbusiness/28iht-hedge.4.8517580.html?pagewanted=all (discussing hedging contracts); Jad Mouawad, *Pushing 40, Southwest Is Still Playing the Rebel*, N.Y. TIMES, Nov. 20, 2010, http://www.nytimes.com/2010/11/21/business/21south.html?_r=0&adxnnl=1&pagewanted=all&adxnnlx=1412053205-XUPcBkSQRSqYMhz0cs3VAQ (discussing the evolution of management strategy at Southwest); Joe Brancatelli, *Southwest Airlines' Seven Secrets for Success*, WIRED (July 8, 2008), http://archive.wired.com/cars/futuretransport/news/2008/07/portfolio_0708 (discussing pricing strategy and other management decisions facilitating success at Southwest).

experience; respond with compassion when travel plans change; generate innovative ideas that enhance the Customer Experience; and donate their time and LUV to those who need it."[4] Commentators suggest that this branding of the company's employees, management's strategic and policy decisions, and the corporate culture cultivated by management give the company a competitive edge.[5] But do these "assets" generate value for the company?

This Article suggests that yes, they do. Specifically, this Article posits that variables commonly classified as unidentifiable intangibles, including management, employees, and their respective talents and ideas (including the value of an "assembled workforce"); synergies created by operational efficiencies among divisions and affiliates, as well as strategic decisions, business plans, and applicable law (including the value of "assembled assets"); and relationships among the company's people and its customers, vendors, and community (referred to collectively here as "soft variables"), all contribute meaningful value to the operation of the company as a going concern.[6]

Soft variables exist in every company, regardless of its size or industry. Nevertheless, commentators devote relatively little attention to these variables, perhaps because of their illusive nature.[7] The precise value of these variables is difficult to capture or quantify, and it may fluctuate sig-

4. SOUTHWEST AIRLINES, ONE REPORT 36 (Dec. 31, 2010) (discussing role of employees and culture in Southwest's business model), *available at* http://www.southwestonereport.com/_pdfs/People.pdf.

5. *See, e.g.*, William J. Holstein, *At Southwest, the Culture Drives Success*, BUSINESSWEEK (Feb. 21, 2008), http://www.businessweek.com/stories/2008-02-21/at-southwest-the-culture-drives-successbusinessweek-business-news-stock-market-and-financial-advice (explaining the importance of Southwest's culture and role of employees in the business model); Sandra J. Miles & W. Glynn Mangold, *Positioning Southwest Airlines Through Employee Branding*, 48 BUS. HORIZONS 535, 536 (2005) (same); Micah Solomon, *Shake Up Your Corporate Culture by Consulting Southwest Airlines' Customer-Centric Approach*, FORBES (Sept. 28, 2013, 9:06 AM), http://www.forbes.com/sites/micahsolomon/2013/09/28/build-a-corporate-culture-to-rival-southwest-airlines-ideally-before-you-leave-for-your-next-lunch-break/ (same); *see also* ERIC G. FLAMHOLTZ & YVONNE RANDLE, CORPORATE CULTURE: THE ULTIMATE STRATEGIC ASSET (2011) (discussing role of corporate culture in performance success at various companies, including Southwest); sources cited *supra* note 3.

6. This Article uses the term "soft variables" in a limited and context-specific manner. *See infra* notes 39–40 and accompanying text. Notably, the term "variable" is commonly defined as "something that changes or can be changed," which aligns with the people, synergy, and relationships included within the term soft variables for purposes of this Article. MERRIAM-WEBSTER ONLINE, http://www.merriam-webster.com/dictionary/variable.com (last visited Nov. 5, 2014). Moreover, the term soft variables is often used in statistical analysis to refer to factors that are not "readily quantifiable." *See, e.g.*, Lawrence Tribe, *Trial by Mathematics: Precision and Ritual in the Legal Process*, 84 HARV. L. REV. 1329, 1361–62 (1971). That description applies with equal force to the people, synergy, and relationships discussed in this article that frequently are ignored or undervalued in the reorganization process. *See infra* Part IV.B. For a general definition of "unidentifiable intangibles" see JEFFREY A. COHEN, INTANGIBLE ASSETS: VALUATION AND ECONOMIC BENEFIT 47–60 (2005) (describing unidentifiable intangibles in accounting context as goodwill and other internally developed assets at a company). Although unidentifiable intangibles are identified as "goodwill" for accounting purposes, this Article considers the importance and value of these variables independently.

7. Although the literature on the legal characterization and value of soft variables is sparse, commentators have discussed and recognized the value of a company's workforce and human capital. *See, e.g.*, Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247, 250 (1999).

nificantly based on the perception of the evaluator.[8] For example, the delta between the liquidation value of a company's tangible and identifiable intangible assets (e.g., contracts, patents, and trademarks) and the company's going concern value arguably represents the value of soft variables, but this value will vary based on, among other things, the perceptions of the market and potential acquirers.[9] Valuation challenges should not, however, discount the relevance of soft variables to a company's going concern value.

This Article explores the value of soft variables in the context of financial distress. A company, even if it is experiencing financial distress or undergoing a restructuring, cannot operate or generate value without soft variables. They are necessary and integral components of enterprise value. Yet, unlike an airplane owned outright or a hanger leased by agreement, a company cannot realize value from, or transfer, soft variables independently from the whole.

A company can, however, use the value of soft variables to facilitate an effective reorganization. Indeed, companies and their creditors frequently argue in favor of a sale of substantially all of the company's assets under section 363 of the Bankruptcy Code (the "Code") or confirmation of a plan of reorganization under section 1129 of the Code by suggesting that the chosen restructuring path will generate more value than a straight liquidation of the company.[10] This Article argues that the additional value is attributable, at least in part, to soft variables.

The general principle that soft variables hold value is easy to articulate, but difficult to dissect. Soft variables themselves are not the company's personal property. The company cannot own, possess, or sell its

8. *See* COHEN, *supra* note 6. Admittedly, as discussed *infra* Part IV.B, measuring the value of soft variables may be challenging and may vary depending on the specialization at issue and the replacement costs involved. *Accord* Tribe, *supra* note 6 (discussing the undervaluation of soft variables in decision-making generally and noting the common perception that "[i]f you can't count it, it doesn't exist"). Nevertheless, this Article considers the independent potential value of soft variables.

9. *See, e.g.*, ROBERT PARRINO & DAVID S. KIDWELL, FUNDAMENTALS OF CORPORATE FINANCE 600 (2009) ("Going-concern value reflects the value associated with additional cash flows the business is expected to produce because of the way in which individual assets are managed together.").

10. *See*, *e.g.*, Fields Station LLC v. Capitol Food Corp. of Fields Corner (*In re* Capitol Food Corp. of Fields Corner), 490 F.3d 21, 25 (1st Cir. 2007) (noting that the primary purposes of reorganization are to preserve the business as a going concern and maximize the value of the assets); *In re* Integrated Telecom Express, Inc., 384 F.3d 108, 120–21 (3d Cir. 2004) (noting that "orderly liquidation is likely to produce more value—or to avoid more loss—than piecemeal liquidation; and . . . going-concern value is likely to be higher than liquidation value") (citing Elizabeth Warren, *Bankruptcy Policymaking in an Imperfect World*, 92 MICH. L. REV. 336, 350 (1993)); Stephens Indus., Inc. v. McClung, 789 F.2d 386, 390 (6th Cir. 1986) (approving the sale of a radio station that could not meet its operating expense obligations and would lose substantial value if it ceased operations); Spencer C. Robinson, Comment, *Keeping Secured Lending Secure: The Limited Legacy of Chrysler's § 363 Bankruptcy*, 14 N.C. BANKING INST. 515, 524 (2010) ("The benefits of § 363 sales are numerous for both debtors and creditors. First, as the Second Circuit noted, 'the speed of the process can maximize asset value by sale of the debtor's business as a going concern.' Also, because the assets are sold clear of liens, a § 363 sale often provides for the highest possible return on the asset. This may allow for an otherwise unattainable recovery for junior creditors. Further, § 363 sales in conjunction with a Chapter 11 filing offer substantial cost reduction over a Chapter 11 filing alone. Section 363 sales can quickly address a substantial amount of creditor's claims on debtor's assets, thus reducing the administrative cost and complexity of a subsequent Chapter 11 filing.") (footnotes omitted).

people or their ideas, decisions, and relationships.[11] The company does, however, have an interest in any value generated by soft variables. That interest is the company's personal property and the allocation of its value may hold significance for the company's future productivity. Indeed, if those investing in the company through soft variables do not stand to benefit from those efforts, the future value of those variables and the company's assets dependent on them may dissipate.

The challenge then is to identify and balance the potential competing claims to any value generated by soft variables. For example, a secured lender may argue that either soft variables or their value are subject to the lender's security interest. But is that the correct position under applicable law or the optimal value allocation from a public policy perspective? And if a company does not realize value from soft variables until after a bankruptcy filing, should that value be allocated to, or shared with, junior creditors or equity holders? Is the economic value generated by soft variables sufficient to warrant a valuation and allocation fight, particularly when a company is already distressed?

There are no easy answers to these questions. This Article explores the issues and competing policy concerns. It also suggests one way to recognize and allocate the value of soft variables—earmark that value for parties contributing to the value-triggering event. Those parties may include employees, certain contract parties, and even lenders. The implementation of this approach would be complex, and it is not the only way to balance the competing considerations. Ultimately, this Article's objective is to encourage a dialogue about the role of soft variables in restructurings—a critical part of any going concern that has been largely ignored and undervalued in the literature.

II. THE NATURE OF SECURED CREDIT

A company can capitalize its business through a variety of debt and equity securities. Although commentators debate the optimal debt-to-equity ratio for any particular company, most agree that some level of debt capitalization is desirable.[12] Debt can discipline management, reduce

11. Issues concerning whether an employee or the employer owns (1) intellectual property generated by the employee, or (2) knowledge imparted to the employee by the employer are subject to ongoing debate. *See, e.g.*, Katherine V.W. Stone, *Knowledge at Work: Disputes Over the Ownership of Human Capital in the Changing Workplace*, 34 CONN. L. REV. 721, 723 (2002) (discussing legal disputes involving covenants not to compete and knowledge obtained by an employee in the workplace). The resolution of those debates is not critical to the thesis of this Article; rather, soft variables discussed here focus on the value of the people themselves and not any identifiable intangible assets produced or received by those people. Indeed, one of the valuation challenges identified in this Article is the complex, multifaceted nature of what we commonly call "goodwill," and the need to allocate goodwill to the asset or variable generating its value. *See infra* part IV.B.

12. *See, e.g.*, RICHARD A. BREALEY & STEWART C. MEYERS, PRINCIPLES OF CORPORATE FINANCE 447–66 (5th ed. 1996) (discussing the factors that weigh against too much and too little debt); Franco Modigliani & Merton H. Miller, *The Cost of Capital, Corporation Finance and the Theory of Investment*, 48 AM. ECON. REV. 261, 264 (1958) (explaining that a company's capital structure is irrelevant in many circumstances and that companies should instead focus on transactions that increase

agency costs, generate tax benefits, and facilitate the most effective use of a company's resources.[13] Debt also can, however, limit the utility of a company's assets, restrict management discretion, foreclose potential value-generating opportunities, and accelerate a company's ultimate demise.

A company with an overleveraged capital structure faces multiple financial and operational challenges. The company likely cannot service some or all of its debt, finance existing or necessary new projects, obtain substitute financing on reasonable market terms, or even obtain market-based trade credit.[14] All classes of debt, as well as off-balance-sheet liabilities, may contribute to a company's overleveraged financial condition, but it is typically the company's level of funded indebtedness that causes immediate concerns.

Funded debt instruments—whether secured or unsecured—contain periodic payments, covenant restrictions, and cross-default/cross-acceleration provisions.[15] A company's inability to make an interest payment under an unsecured bond issuance, for example, typically not only causes a default under that bond indenture but also with respect to most, if not all, of the company's secured debt.[16] As described below, a company's secured debt instruments frequently include the tightest covenants and potentially significantly affect all of the company's assets.[17] Consequently, although not always the triggering event, a company's secured

their market valuation); Joseph E. Stiglitz, *On the Irrelevance of Corporate Financial Policy*, 64 AM. ECON. REV. 851, 851 (1974) (building on and illustrating Modigliani and Miller's theory).

13. *See, e.g.*, Gregor Andrade & Steven N. Kaplan, *How Costly is Financial (Not Economic) Distress? Evidence from Highly Leveraged Transactions that Became Distressed*, 53 J. FIN. 1443, 1446 (1998) (explaining perceived costs and benefits of debt); Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 305 (1976) (explaining agency costs in corporate governance); Clifford W. Smith & Jerold B. Warner, *On Financial Contracting: An Analysis of Bond Covenants*, 7 J. FIN. ECON. 117, 152 (1979) (exploring agency costs issues in context of debt).

14. For a general discussion of the challenges facing financially distressed companies, see EDWARD I. ALTMAN & EDITH HOTCHKISS, CORPORATE FINANCIAL DISTRESS AND BANKRUPTCY (3d ed. 2006).

15. *See generally* Smith & Warner, *supra* note 13 (examining bond structures in light of debt-equity conflict); Charles K. Whitehead, *The Evolution of Debt: Covenants, the Credit Market, and Corporate Governance*, 34 J. CORP. L. 641, 650 (2009) (reviewing debt instruments and market implications). For a concise description of high-yield bond covenants, including default provisions, see William J. Whelan, *Bond Indentures and Bond Characteristics*, *in* LEVERAGED FINANCIAL MARKETS: A COMPREHENSIVE GUIDE TO LEANS, BONDS, AND OTHER HIGH-YIELD INSTRUMENTS 171 (William F. Maxwell & Mark R. Shenkman eds., 2010), *available at* http://www.cravath.com/files/Uploads/Documents/Publications/3234772_1.PDF.

16. *See generally* Marcel Kahan, *The Qualified Case Against Mandatory Terms in Bonds*, 89 NW. U. L. REV. 565, 611 (1995) ("For companies, the penalty for violating [financing terms] is high: bondholders might declare a default and accelerate the repayment of their bonds, which in turn may trigger a cross-default on other debt and force even a healthy company into bankruptcy."); Stephen R. Kruft, *Cross-Default Provisions in Financing and Derivatives Transactions*, 113 BANKING L.J. 216, 216–20 (1996) (noting the common presence of cross-default provisions in financing agreements and discussing the dual purpose of such provisions: to permit the lender to participate in work-out negotiations that may not be directly applicable to the lender in order to protect itself from less advantageous treatment under a work-out and to permit the lender to terminate the agreement if it believes the borrower will not perform its obligations).

17. *See infra* Part II.A.

debt may present the most significant potential barrier to a successful restructuring.

A. The Increasing Use of Term Lending and Blanket Liens

The world of corporate finance, including secured credit, has changed. Both the identity of the lenders and the types of lending instruments are different and more complex. I have discussed elsewhere the shift from relationship lending with traditional banks to a more investor-centric lending environment dominated by financial institutions and private funds.[18] The virtues of this shift depend on whom you ask, but the shift itself is undeniable.

Likewise, the lending community has shifted from primarily asset-based lending ("ABL"), with lenders holding liens in particular collateral, to primarily term lending, with lenders holding liens in substantially all of a company's assets (i.e., the blanket lien).[19] Term lending of this nature prices the credit and evaluates the related risks based on the enterprise value of the company.[20] Whether a lender can capture the entirety of a company's enterprise value under state law is discussed *infra* Part III.D. Regardless, lenders are extending term loans on this basis, and financial markets are valuing companies, including distressed companies, accordingly.

As a practical matter, term lending and high yield bonds supported by a blanket lien places the secured lenders in a controlling position, particularly as a company slides closer to financial distress. Among other things, events of default under the secured credit instruments arguably give the secured lenders the right to foreclose on the company—not just a crane or the machinery at a particular plant, but the company itself.[21] Moreover, revisions to Article 9 of the Uniform Commercial Code (the "UCC") simplified the process for perfecting blanket liens, making technical challenges to secured lenders' foreclosure rights essentially nonex-

18. *See* Michelle M. Harner, *Activist Distressed Debtholders: The New Barbarians at the Gate?*, 89 WASH. U. L. REV. 155, 157 (2011); Michelle M. Harner, *The Search for an Unbiased Fiduciary in Corporate Reorganizations*, 86 NOTRE DAME L. REV. 469, 494 (2011); *see also* Kenneth M. Ayotte & Edward R. Morrison, *Creditor Control and Conflict in Chapter 11*, 1 J. LEGAL ANALYSIS 511, 513 (2009); Douglas G. Baird & Robert K. Rasmussen, *Private Debt and the Missing Lever of Corporate Governance*, 154 U. PENN. L. REV. 1209, 1212 (2006); Stuart C. Gilson & Michael R. Vetsuypens, *Creditor Control in Financially Distressed Firms: Empirical Evidence*, 72 WASH. U. L. Q. 1005, 1007 (1994); David A. Skeel, Jr., *The Past, Present and Future of Debtor-in-Possession Financing*, 25 CARDOZO L. REV. 1905, 1907 (2004); David A. Skeel, Jr., *Creditor's Ball: The "New" New Corporate Governance in Chapter 11*, 152 U. PA. L. REV. 917, 918 (2003); William W. Bratton, *Bond Covenants and Creditor Protection: Economics and Law, Theory and Practice, Substance and Process* 17 (Geo. Bus. Econ. Reg. L. Res. Paper No. 902910 2006).

19. *See* Ayotte & Morrison, *supra* note 18, at 523 (noting that ninety-seven percent of prepetition financing facilities are secured by all or nearly all of the firm's assets).

20. *See* Jay Lawrence Westbrook, *The Control of Wealth in Bankruptcy*, 82 TEX. L. REV. 795, 815–16 (2004) (discussing the value of creditor claims in asset-based lending and blanket liens).

21. *See, e.g.*, *In re* Pullman Const. Indus. Inc., 107 B.R. 909, 938–39 (Bankr. N.D. Ill. 1989) (holding debtor's plan of reorganization could not be confirmed because plan did not provide creditor (with a blanket lien) the full going concern value of all its collateral).

istent.[22] The company and junior stakeholders thus frequently possess little negotiating leverage, and are presented with the choice of accepting the secured lenders' terms or losing the business.[23]

Stated in these general terms, this result and the unleveled negotiating plane may appear unjust. The company has many constituencies impacted by the secured lenders' decisions. Yet, those junior creditors, shareholders, employees, and others do not have a seat at the negotiating table or a say in the treatment of the company or its assets. Those constituencies arguably have added value to the company during the term of the loan through trade credit, services, and other investments.[24] This perception may be strongest when the company's financial distress relates primarily to general market or industry conditions, and is not company-specific as a result of, for example, mismanagement or product obsolescence.

Secured lenders likely see the situation differently. From their perspective, they gave the company cheaper credit terms based on their valuation of the collateral package and foreclosure rights; they gave the company an opportunity to comply with the terms of the contract and repay the term loan; and they are entitled to the full benefit of their bargain when the company defaults or is approaching default.[25] In addition, the secured lenders' control position results not only from their contract, but also from the lower recovery priorities presumably negotiated and priced by the other constituencies.[26] From the secured lenders' perspective, the negotiating plane is perfectly balanced.

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22. *See, e.g.*, Larry T. Garvin, *The Changed (And Changing?) Uniform Commercial Code*, 26 FLA. ST. U. L. REV. 285, 344 n.359 (1999) (discussing the more favorable perfection rules); Catherine E. Vance & Paige Barr, *The Facts & Fiction of Bankruptcy Reform*, 1 DEPAUL BUS. & COM. L.J. 361, 379–80 (2003) (discussing the effects of the revised UCC Article 9 on secured creditor power over the debtor's assets); G. Ray Warner, *Article 9's Bankruptcy Proceeds Rule: Amending Bankruptcy Code Section 552 Through the UCC "Proceeds" Definition*, 46 GONZ. L. REV. 521, 525 (2011) (discussing how the revisions to Article 9 favor secured creditors to the detriment of the debtor and other creditors).

23. With the advent of loan-to-own credit, this choice may be a distinction without a difference. The secured lenders' terms may in fact require a change of control transaction in which they end up owning the company.

24. Although state and federal law determine priorities among various creditor classes, the extensive use of blanket liens arguably was unforeseen and undercut balance of existing priority schemes.

25. Lois R. Lupica, *The Impact of Revised Article 9*, 93 KY. L.J. 867, 868, 890–91 (2005) (noting the revisions to Article 9 were designed, in part, to increase the availability of secured credit at reduced cost and increase lending efficiency).

26. *See, e.g.*, Barry E. Adler, *Financial and Political Theories of American Corporate Bankruptcy*, 45 STAN. L. REV. 311, 329 (1993) (arguing that judge-supervised reorganizations may no longer be necessary or desirable due to sophisticated contractual financing arrangements); Douglas G. Baird & Robert K. Rasmussen, *The End of Bankruptcy*, 55 STAN. L. REV. 751, 777–85 (2002) (same) (discussing the positive role of senior financing contracts, and other contracts, in firm reorganization). *But see* Lynn M. LoPucki, *The Nature of the Bankrupt Firm: A Response to Baird & Rasmussen's The End of Bankruptcy*, 56 STAN. L. REV. 645, 652 (2003) [hereinafter LoPucki, *The Nature of the Bankrupt Firm*] (taking a more expansive view of going-concern value and positing, "Baird and Rasmussen's premise that going-concern value can exist only in conjunction with firm-specific assets is wrong. Going-concern value resides principally in relationships").

Irrespective of which perspective is correct, the debate should focus on priority and value allocation and, in theory, should not impact the value of the company. Nevertheless, anecdotal evidence suggests that actual or perceived secured lender control over the direction of a company approaching distress does impact value.[27] The next Section briefly addresses this issue; the Article then considers the relationship among soft variables, secured lenders' entitlements, and value allocation.

B. Asset Sales, Reorganizations, and Value

Most every distressed company grapples with identifying the strategic alternative that preserves or maximizes its value. A company typically analyzes a variety of restructuring alternatives: from an out-of-court workout, to a prepackaged or full-blown Chapter 11 reorganization, to a quick going concern sale.[28] The company may favor reorganization as a means to maintain the business and, some would say, benefit entrenched management.[29] Secured lenders may favor a quick sale, either to liquidate their positions as quickly as possible or to obtain control of the future direction of the company.[30] In either scenario, a change of control will likely occur unless the company projects operational value sufficient to pay all creditors in full with interest and maintain existing shareholder interests.

Several commentators have observed a shift in change of control transactions in Chapter 11 from stand-alone reorganizations, where the company is reorganized under the direction of management, with creditors receiving at least part of the reorganized equity, to going concern asset sales under section 363 of the Code.[31] In the section 363 context, the

27. *See* Barry E. Adler, Vedran Capkun & Lawrence A. Weiss, *Value Destruction in the New Era of Chapter 11*, 29 J. L. ECON. & ORG. 461 (2013), *available at* http://ssrn.com/abstract=1291620 (finding that creditor control may exacerbate managerial incentive to delay filing for bankruptcy and observing that such delays have a negative impact on firm value); Ayotte & Morrison, *supra* note 18, at 514 (finding that bankruptcy sales are more likely and reorganization is less likely when the debtor's secured creditors are oversecured, often to the detriment of unsecured creditors); Melissa B. Jacoby & Edward J. Janger, *Ice Cube Bonds: Allocating the Price of Process in Chapter 11 Bankruptcy*, 123 YALE L.J. 862, 918 (2014).

28. *See, e.g.*, Michelle M. Harner, *The Corporate Governance and Public Policy Implications of Activist Distressed Debt Investing*, 77 FORDHAM L. REV. 703, 729, 765 (2008) (discussing some of the restructuring alternatives). Kmart management, for example, took the time to analyze the firm's reorganization strategy, deciding to "take its time in bankruptcy to fix operational problems." *Id.* at 750–51.

29. Michael Bradley & Michael Rosenzweig, *The Untenable Case for Chapter 11*, 101 YALE L.J. 1043, 1045–46 (1992) (noting that "managers will always prefer reorganization to liquidation as a form of bankruptcy protection because reorganization may permit managers to effect wealth transfers from creditors (and perhaps other stakeholders) to equity holders"); *see id.* at 1046 n.13.

30. Stuart C. Gilson, *Investing in Distressed Situations: A Market Survey*, FIN. ANALYSTS J., Nov.–Dec. 1995, at 8, 23; *see also* J. Bradley Johnston, *The Bankruptcy Bargain*, 65 AM. BANKR. L.J. 213, 246–48 (1991) (discussing the secured creditors focus on liquidation value, preference for immediate payment, and desire to prevent dissipation of the collateral); Elizabeth Warren, *Making Policy with Imperfect Information: The Article 9 Full Priority Debates*, 82 CORNELL L. REV. 1373, 1390 (1997) ("Secured creditors want their assets now, even if it means killing a going concern.").

31. At least in the context of large public company bankruptcies, outcomes are trending towards an increase in asset sales. *See* Appendix A (presenting empirical data on issue); *see also* Baird &

sale may result from the terms of the prepetition lending instruments, limitations on the use of cash collateral because of an inability to provide adequate protection, or the debtor in possession financing agreement.[32] The sale may also represent the restructuring alternative that maximizes the company's value and is supported by the various constituencies. Every case is slightly different, yet the primary dispute is largely the same: what restructuring alternative maximizes the company's value.[33]

Several factors make resolving this value issue difficult. The timing of the resolution impacts value: some will argue a quick sale is necessary to maximize value, while others will argue that, in certain cases, a quick sale steals value that could be realized for junior creditors through a reorganization or more methodical sale process.[34] The type of resolution matters: in an asset sale, the bidders and ultimate purchaser influence the value, whereas in a reorganization, the feasibility of a plan and the deemed value available for creditors generally is determined through a judicial valuation by a variety of valuation methods, such as a discounted cash flow analysis.[35] The party controlling the process may matter: secured creditors may want to liquidate their claims quickly or own the company outright; the company and employees may want to avoid a sale at all costs; and junior creditors may be divided on the best approach, or at least object to the plan proposed by the company.[36]

The value of a company's soft variables and the identity of the parties who may have an interest in those variables affect each of these factors. They influence whether the company generates more value as a going concern than in a piecemeal sale and the motivations of the parties, including employees and counterparties, to work towards a value-maximizing plan. Soft variables are an often overlooked but important piece of the restructuring puzzle.

Rasmussen, *supra* note 26, at 751 (stating that traditional reorganizations have all but disappeared); Lynn M. LoPucki & Joseph W. Doherty, *Bankruptcy Fire Sales*, 106 MICH. L. REV. 1, 42–43 (noting there was an increase in bankruptcy sales from 1988 to 2002 but steeply declined thereafter).

32. *See, e.g.*, Baird & Rasmussen, *supra* note 18, at 1219–20 (discussing use of milestones and other control mechanisms in financing documents).

33. Harvey R. Miller & Shai Y. Waisman, *Does Chapter 11 Reorganization Remain a Viable Option for Distressed Businesses for the Twenty-First Century?*, 78 AM. BANKR. L.J. 153, 194 (2004) (discussing various arguments regarding the role of Chapter 11 and noting that some of the arguments fail to account for the fact that "one of the fundamental precepts of Chapter 11 is maximizing and allocating return to creditors").

34. *See* Richard M. Hynes, *Reorganization as Redemption*, 6 VA. L. & BUS. REV. 183, 199 (2011) ("[T]he timing and manner of [a Chapter 11] sale will affect the price paid. Senior claimants are likely to prefer a quick sale that minimizes both expenses and the risk of depreciation, while junior claimants are likely to prefer a lengthy process that maximizes the chance of a very high bid.").

35. *See, e.g.*, Douglas G. Baird & Donald S. Bernstein, *Absolute Priority, Valuation Uncertainty, and the Reorganization Bargain*, 115 YALE L.J. 1930, 1939, 1941–42 (2006) (discussing junior and senior creditors different views of an accurate valuation by the market, in a sale situation, and also other methods of valuing the firm including predictions regarding future cash flows).

36. *See id.* at 1939 (discussing diverging interests of junior and senior creditors); Ayotte & Morrison, *supra* note 18, at 514 (discussing diverging interests of various constituents in the context of creditor control and conflict).

III. POTENTIAL CLAIMS TO A COMPANY'S SOFT VARIABLES

If soft variables represent value, who owns or is entitled to that value becomes important in the distressed company context. Arguably, the company is entitled to the value generated by soft variables. That conclusion does not necessarily mean the company owns or possesses soft variables; in many cases, soft variables arise from the voluntary participation in the company business of various parties, like employees. This distinction is relevant to what exactly a company can and cannot offer as collateral to a secured lender and the extent of the secured lender's rights, if any, in soft variables.[37] This Part considers a series of questions to analyze the parties' respective claims to soft variables, and whether the filing of a Chapter 11 bankruptcy case alters those claims.

A. What Are Soft Variables?

The term "soft variables" and the related terms "soft assets" and "soft inputs" have different meanings depending on the disciplinary context and the purpose of their use.[38] In this Article, I invoke a limited definition of the term "soft variables" based loosely on the accounting concept of unidentifiable intangibles that includes:[39]

- The company's people (e.g., executives, managers, employees) and their respective talents and ideas, including the value of an "assembled workforce" (collectively, "people");
- The synergies created by operational efficiencies among divisions and affiliates, as well as strategic decisions, business plans, and applicable law, including the value of "assembled assets" (collectively, "synergy");
- The relationships among the company's people and its customers, vendors, and community (collectively, "relationships").

37. *See infra* Parts III.C., III.D.

38. For example, some commentators use the term "soft assets" to indicate intangible assets on a company's balance sheet. *See, e.g.*, Patricia M. DeChow et al., *Predicting Material Accounting Misstatements*, 28 CONTEMP. ACCT. RES. 17, 19 (2011) ("We measure the percentage of 'soft' assets on the balance sheet (defined as the percentage of assets that are neither cash nor property, plant, and equipment (PP&E).").

39. *See supra* notes 6–8 and accompanying text; *see also* B.K. BANERJEE, FINANCIAL ACCOUNTING: CONCEPTS, ANALYSES, METHODS AND USES 405–06 (2010) (explaining concept of unidentifiable intangibles and goodwill in accounting context). As discussed in the Introduction, this Article does not use the term to reference the entirety of a company's goodwill. Nevertheless, it does include elements of "human capital" in the term soft variables. *See, e.g.*, Margaret M. Blair et al., *Clarifying Intellectual Property Rights for the New Economy*, *in* FROM IDEAS TO ASSETS: INVESTING WISELY IN INTELLECTUAL PROPERTY 84–85 (Bruce Berman ed., 2002) (recognizing value of "human capital, core competencies, organizational capital, and relationship capital"); Joellen Riley, *Who Owns Human Capital? A Critical Appraisal of Legal Techniques for Capturing the Value of Work*, 18 AUST. J. OF LABOUR L. 1, 3 (2005) ("A body of literature, much of it emerging from law and economics scholarship, describes human capital as the valuable contribution made to enterprise by the work and attributes of people.").

As so defined, soft variables interact with the company's tangible and identifiable intangible assets, but they are separate from and independent of those assets.[40] The value of these soft variables also depends largely on the actions of natural persons. Even the synergy component does not derive from physical assets, but from the decisions of the people running the company and the policymakers governing the company. This feature distinguishes these soft variables from intangible assets generally characterized as a company's personal property.[41]

B. What Is Property?

"Property" is a fluid concept. The legal characterization of property once focused on objects and the rights associated with those objects.[42] The law gradually shifted its focus to the relationships surrounding the ownership of property, commonly referred to as the "bundle of rights" approach.[43] Notably, property scholars debate which theory, or alternative theories, should drive our conception of property under the law.[44]

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40. Studies describe the type of soft variables discussed in this article as internally generated human and structural capital that is "unidentifiable" or "inseparable and uncontrolled." *See, e.g.*, Gîju George Cipran et al., *From Visible to Hidden Intangible Assets*, 62 SOC. & BEHAV. SCI. 682, 684 (2012) (Figure 2 from this article depicting break down of Intangible Assets is reproduced [with permission] at Appendix B).

41. Intangible assets are generally defined as "[a]ssets that manifest themselves by their economic properties. They do not have physical substance." INTERNATIONAL VALUATION STANDARDS, GUIDANCE NOTE NO. 4, at 248 (6th ed. 2003). Similarly, FAS No. 141 defines intangible assets as "assets lack[ing] physical substance." FINANCIAL ACCOUNTING STANDARDS BOARD, *Statement of Financial Accounting Standards No. 141*, FIN. ACCT. SERIES, Dec. 2007, at i, 3. Under FAS No. 141, an asset is identifiable if:

> (1) Is separable, that is, capable of being separated or divided from the entity and sold, transferred, licensed, rented, or exchanged, either individually or together with a related contract, identifiable asset, or liability, regardless of whether the entity intends to do so; or
>
> (2) Arises from contractual or other legal rights, regardless of whether those rights are transferable or separable from the entity or from other rights and obligations.

Id. Common examples of identifiable assets are patents, trademarks, and copyrights. Goodwill generally is not considered an identifiable intangible asset. *See, e.g.*, BANERJEE, *supra* note 39, at 405–06.

42. *See, e.g.*, Robert G. Bone, *Hunting Goodwill: A History of the Concept of Goodwill in Trademark Law*, 86 B.U. L. REV. 547, 584 (2006) ("Clear definitions and easily ascertainable boundaries were important features of property within the formalist view, which imagined an owner possessing a thing by exercising physical control over it."); Kenneth J. Vandevelde, *The New Property of the Nineteenth Century: The Development of the Modern Concept of Property*, 29 BUFF. L. REV. 325, 328–29, 330–31 (1980) (discussing the early conception of property as dominion over "things" and how property rights evolved such that "[a]ny valuable interest potentially could be declared the object of property rights"); *see also* David Lametti, *The Concept of Property: Relations Through Objects of Social Wealth*, 53 U. TORONTO L.J. 325 (2003).

43. Property rights were redefined as a set of legal relations among persons and no longer as dominion over things, and eventually characterized as a bundle of rights. Vandevelde, *supra* note 42, at 330, 360–61; *see, e.g.*, GRANT S. NELSON ET AL., CONTEMPORARY PROPERTY 13–14 (4th ed. 2013) (describing bundle of rights approach as rights "that may be exercised with respect to [an] object"); Craig Anthony Arnold, *The Reconstitution of Property: Property as a Web of Interests*, 26 HARV. ENVTL. L. REV. 281, 282 (2002) ("The bundle of rights concept of property replaced a physicalist, absolutist understanding of property."); *see also* Denise R. Johnson, *Reflections on the Bundle of Rights*, 32 VT. L. REV. 247 (2007) (reviewing the development and implementation of the bundle of rights concept).

44. *See generally* JAMES W. ELY JR., 6 MAIN THEMES IN DEBATE OVER PROPERTY RIGHTS (1997) (addressing the complex issues associated with understanding and applying property rights);

This Article does not try to engage in that dispute; rather, it accepts the bundle of rights approach as the approach favored by many judges and commentators.

The bundle of rights approach generally considers factors such as "use, alienation, exclusion, and possession."[45] Although not an exhaustive list, these factors capture the essence of the bundle of rights inquiry: does a person have an interest entitled to legal protection?[46] Indeed, the approach developed in part to address the increasing presence of intangible assets in the marketplace.[47] A legal test focused on the physicality of an object or thing would not necessarily extend to contracts, copyrights, trademarks, or other intellectual assets. A test analyzing a person's rights to, among other things, possess the asset, exclude others from using it, and sell the asset, however, casts a wider and much more flexible net of legal protection.

One intangible asset closely related to soft variables is goodwill. In the business context, goodwill has been defined as:

> A going business has a value over and above the aggregate value of the tangible property employed in it. Such excess of value is nothing more than the recognition that, used in an established business that has won the favor of its customers, the tangibles may be expected to earn in the future as they have in the past. The owner's privilege of so using them, and his privilege of continuing to deal with customers attracted by the established business, are property of value. This latter privilege is known as goodwill.[48]

Courts have expanded this definition to recognize value derived from intellectual assets, trademarks in particular, as a form of goodwill.[49]

Goodwill historically has received varying degrees of protection as personal "property" under the law. In the context of acquisitions, misappropriation, and some economic torts, for example, business goodwill is characterized as property.[50] It is not, however, consistently treated as property for purposes of eminent domain and the Takings Clause under

STUART BANNER, AMERICAN PROPERTY 45–73 (2011); *see also* Arnold, *supra* note 43, at 283–84; J.E. Penner, *The "Bundle of Rights" Picture of Property*, 43 UCLA L. REV. 711, 714 (1996).

45. *See* Arnold, *supra* note 43, at 283; NELSON ET AL., *supra* note 43, at 13–14.

46. Arnold, *supra* note 43, at 285 ("'The central premise of the bundle of rights conception of property is that property is a set of legal relationships among people . . . .'"(citation omitted)); *see* Penner, *supra* note 44, at 719–20, 754 (noting that the law may limit some rights over certain forms of property, "yet what remains is still deemed in the law to be a protectable property interest").

47. *See, e.g.*, Bone, *supra* note 42, at 586–87; Vandevelde, *supra* note 42, at 333–40 (describing the evolution from property as tangible items to a right because of the rise in litigation regarding intangible property, including intellectual property and goodwill).

48. Haberle Crystal Springs Brewing Co. v. Clarke, 30 F.2d 219, 221 (2d Cir. 1929), *rev'd on other grounds*, 280 U.S. 384 (1930).

49. *See, e.g.*, Bone, *supra* note 42, at 586–89; Green River Bottling Co. v. Green River Corp., 997 F.2d 359, 362 (7th Cir. 1993) (holding that a trademark may not be sold separately from the goodwill associated with the trademark); Sugar Busters LLC v. Brennan, 177 F.3d 258, 265 (5th Cir. 1999) ("A trademark is merely a symbol of goodwill and has no independent significance apart from the goodwill that it symbolizes." (citing Marshak v. Green, 746 F.2d 927, 929 (2d Cir. 1984))).

50. *See supra* note 42 and accompanying text.

the Fifth Amendment.[51] Moreover, personal goodwill (i.e., goodwill generated by a natural person) is often separated from business goodwill, and may not constitute property of any kind.[52]

C. Is a Soft Variable Property?

Soft variables arguably fall within the standard accounting definition of assets: "economic resources with the ability or potential to provide future benefits to a firm."[53] A company does derive value from the intellect of its people, the relationships developed by their people, strategic use of tax or bankruptcy laws, etc.[54] A company may in fact own that value as personal property once recognized, but it does not own the people, their relationships, or their ideas.[55] This conclusion flows not only from the bundle of rights conception of property and the accounting treatment of unidentifiable intangibles, but also from long-standing public policy and Constitutional concerns.[56] The former are analyzed here; the latter are discussed in Part IV.C.

Consider first the legal characterization of property discussed above. A company cannot possess soft variables in a physical sense, or even through the metaphysical concept of control used for intellectual property.[57] A company may have a contractual or common law right to direct the tasks performed by its people, but it does not control exactly how people think, behave, or perform, or the relationships they maintain.[58] The nature of the at-will employment relationship underscores this

51. *See, e.g.*, Michael A. Fragoso, Note, *Taking Conscience Seriously or Seriously Taking Conscience?: Obstetricians, Specialty Boards, and the Takings Clause*, 86 NOTRE DAME L. REV. 1687, 1710–17 (2011) (discussing different treatment of goodwill for purposes of Takings Clause under the Fifth Amendment of the Constitution).

52. *See, e.g.*, Darian M. Ibrahim, *The Unique Benefits of Treating Personal Goodwill as Property in Corporate Acquisitions*, 30 DEL. J. CORP. L. 1 (2005).

53. CLYDE P. STICKNEY & ROMAN L. WEIL, FINANCIAL ACCOUNTING: AN INTRODUCTION TO CONCEPTS, METHODS, AND USES 7 (11th ed. 2006).

54. Human and other intangible capital can contribute to a company's economic success. *See generally* Blair et al., *supra* note 39, at 90 (noting in the context of intangibles such as "human capital, core competencies, organizational capital, and relationship capital" that "[a]lthough they do not meet any of the four accounting criteria for 'assets,' such factors clearly help to create value for corporations"); PHILIP STILES & SOMBOON KULVISAECHANA, HUMAN CAPITAL AND PERFORMANCE: A LITERATURE REVIEW (2003), *available at* http://www.bus.tu.ac.th/usr/sab/articles_pdf/research_papers/dti_paper_web.pdf (collecting literature defining and attempting to measure value of different forms of capital).

55. *See, e.g.*, Blair et al., *supra* note 39, at 90 (stating in the context of human capital and related unidentifiable intangibles, "Corporations do not have legal property rights over these intangibles"). Notably, soft variables involve purely relationship and decisional matters; they do not involve relationships among people *with respect to things*, which drive the current legal definition of property. *See supra* notes 42–47 and accompanying text.

56. *See infra* Part IV.C.

57. *See infra* notes 64 and 126; *see, e.g.*, Stewart E. Sterk, *Restraints on Alienation of Human Capital*, 79 VA. L. REV. 383, 385, 387 (1993) (discussing the treatment of human capital in the context of employment and noting that the limitations on the alienation of human capital are quite different from the legal treatment of more traditional property rights).

58. Sterk, *supra* note 57, at 387–88, 395–96 (noting that a business employer may not obtain specific performance of an employment contract and discussing how covenants not to compete may only be enforceable when considered reasonable by the judiciary); *see infra* notes 59–62.

point. That relationship typically is viewed as a daily exchange of labor for wages, which may be terminated by either party at any time.[59]

A company cannot sell its people on an involuntary basis and may not even have the ability to transfer related contracts without the consent of the employee.[60] Although a company can attempt to mitigate the consequences by contract, the enforceability of covenants not to compete and the availability of specific performance are often limited by the courts.[61] Consequently, a company generally cannot exclude others from using its people or their relationships; it certainly cannot exclude others from invoking regulatory advantages or protections.[62]

The foregoing considerations also explain why soft variables generally are not identified as assets on a company's balance sheet under generally accepted accounting principles, unless identified in connection with a business combination (merger or acquisition—i.e., a triggering event). An asset may be recorded on a company's balance sheet if it is *owned or controlled* by the company and offers *measurable* future benefits to the company.[63] The "owned or controlled" standard is satisfied if a company holds legal title to an asset or the unrestricted right to use the asset.[64] In general, a benefit is measurable if an accountant knows the line item's historical cost or the fair market value. Whatever rights a company

59. *See, e.g.*, Richard A. Epstein, *In Defense of the Contract at Will*, 51 U. CHI. L. REV. 947, 955 (1984) ("So long as it is accepted that the employer is the full owner of his capital and the employee is the full owner of his labor, the two are free to exchange on whatever terms and conditions they see fit . . . .").

60. *See, e.g.*, Brian A. Riddell, *The Ability of Successor Employers to Enforce Covenants Not to Compete*, 33 CAP. U.L. REV. 499, 500 (2004); Adam Schneid, Note, *Assignability of Covenants Not to Compete: When Can a Successor Firm Enforce a Noncompete Agreement?*, 27 CARDOZO L. REV. 1485, 1485–87 (2006).

61. *See, e.g.*, Charles M. Thatcher, *Specific Performance as a Seller Remedy for Buyer's Breach of a Sales Contract—The Availability of Judicial Purchase Orders*, 57 S.D. L. REV. 218 (2012) (discussing, among other things, limitations on specific performance as buyer-only remedy under the UCC); *see also* Theodore Eisenberg & Geoffrey P. Miller, *Damages Versus Specific Performance: Lessons from Commercial Contracts* (NYU Law & Econ. Research Paper No. 334, 2013), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2241654 (discussing the traditional preference for damages over specific performance and countervailing considerations, as well as empirical data suggesting that most commercial contracts do not contain a specific enforcement clause, except in the business combination context); Steven Shavell, *Specific Performance Versus Damages for Breach of Contract* (Harvard Olin Ctr. L. Econ. & Bus. Disc. Paper No. 532, 2005), *available at* http://www.law.harvard.edu/programs/olin_center/papers/pdf/Shavell_532.pdf (empirical data suggesting that parties prefer damages in context of contracts for production of goods and specific performance in context of contracts for conveyance of property).

62. Sterk, *supra* note 57, at 395–96 (discussing enforceability of employment noncompete agreements).

63. WILLIAM J. CARNEY, CORPORATE FINANCE: PRINCIPLES AND PRACTICE 11 (2005). For a thoughtful discussion of the accounting treatment of tangible and intangible assets, including a company's people and reputation, see ROBERT RHEE, ESSENTIAL CONCEPTS OF BUSINESS FOR LAWYERS 12–13, 33 (2012).

64. *See* INTANGIBLE ASSETS Int'l Accounting Standard 38, ¶13 (Int'l Accounting Standards Bd. 2014) ("An entity controls an asset if the entity has the power to obtain the future economic benefits flowing from the underlying resource and to restrict the access of others to those benefits. The capacity of an entity to control the future economic benefits from an intangible asset would normally stem from legal rights that are enforceable in a court of law. In the absence of legal rights, it is more difficult to demonstrate control . . . .") [hereinafter IAS 38].

may have to soft variables cannot meet the exacting "ownership or control" standard imposed for accounting purposes. Likewise, as discussed in Part IV.B, measuring the value of soft variables is difficult and often is triggered by a realization event, such as a sale. Although not determinative, the fact that a company cannot generally claim soft variables as a balance sheet asset is instructive.

Admittedly, some may argue that the accounting treatment of soft variables is irrelevant to their legal characterization and that the relationships associated with soft variables are within a company's bundle of property rights. The control present in the employment relationship or the use of strategically drafted contractual provisions arguably may be sufficient to meet the common attributes of property. The bundle of rights conception of property is imprecise and malleable, which some commentators perceive as problematic.[65] Could we expand the bundle of rights to include soft variables? Do we really want to characterize employees or human relationships as the personal property of the company for which those people work?

Some commentators may argue that the traditional treatment of business goodwill as the company's personal property adequately answers these questions. The accounting and legal definitions of goodwill could be interpreted to include at least certain types of soft variables.[66] Goodwill is an amorphous term, and like the bundle of rights conception of property, could include just about anything.[67]

65. *See* Arnold, *supra* note 43, at 291–306 (critiquing the bundle of rights concept of property); Johnson, *supra* note 43, at 255 (noting that, in context of government regulation, "it was pragmatic to conceive of property ownership as a bundle of rights that was infinitely malleable and adaptable, unhindered by formalistic restraints or narrow conceptions"); Penner, *supra* note 44, at 721–22; Anna di Robilant, *Property: A Bundle of Sticks or a Tree?*, 66 VAND. L. REV. 869, 871 (2013) ("The metaphor suggests that the bundle is malleable (i.e., that private actors, courts, and lawmakers may add or remove sticks, and that the bundle structures relations among persons, only secondarily and incidentally involving a thing).").

66. *See infra* notes 67, 79, 82 and accompanying text (discussing goodwill in business context). In addition, for accounting purposes, goodwill is defined as "'an asset representing the future economic benefits arising from other assets acquired in a business combination that are not individually identified and separately recognised.'" Tracy Gomes, *Defining Goodwill for Transfer Pricing*, 11/12 TRANSFER PRICING INT'L J. 1, 2 (2012), *available at* http://www.mwe.com/files/Publication/673231ae-b7c8-4cfc-802f-15ac36bf03b8/Presentation/PublicationAttachment/f1f5eae2-9bdf-4536-831c-1c971c029ba2/BNA%20-%20Gomes.pdf?PublicationTypes=d4366db4-cfb3-4a31-95e6-f18e3d273c8a,4701733c-9b14-4658-9845-6dd51108a665. For legal purposes, it is typically defined as "'a business's reputation, patronage, and other intangible assets that are considered when appraising the business, esp. for purchase.'" *Id.* (citing BLACK'S LAW DICTIONARY 712 (9th ed. 2009)).
Intangible assets, including goodwill, have been described as "assets that manifest themselves by their economic properties. They do not have physical substance; they grant rights and privileges to their owner and usually generate income for their owner. Intangible assets can be categorized as arising from *Rights, Relationships, Grouped Intangibles,* or *Intellectual Property*." *International Valuation Guidance Note No. 4: Valuation of Intangible Assets*, *in* INTERNATIONAL VALUATION STANDARDS 245, 248 (6th ed. 2003).

67. *See, e.g.*, Smith v. Davidson, 31 S.E.2d 477, 479 (Ga. 1944) (commenting on the illusory nature of goodwill and noting that "[i]t is more like a spirit that hovers over the physical, a sort of atmosphere that surrounds the whole"); *see also* Note, *An Inquiry into the Nature of Goodwill*, 53 COLUM. L. REV. 660 (1953) (reviewing different approaches to defining goodwill and the imprecise definition of the term).

The key case law on property rights does not address the characterization of soft variables as goodwill or as property in any meaningful way.[68] As noted above, goodwill generally is defined as arising from tangible or intangible property owned by the company.[69] If the company does not own soft variables, their value should not be lumped into goodwill. Courts have begun to recognize that goodwill is not a monolithic concept and can be parsed among assets—for example, separating the goodwill associated with a trademark from other kinds of goodwill.[70] Moreover, goodwill is not considered property for all purposes, and some criticize its characterization as property for any purpose.[71] The policy considerations underlying these limitations and critiques are discussed in Part IV.C.

What, then, is a company's interest in soft variables? I posit that it is an interest, arguably a personal property interest, solely in the value generated from soft variables. The next logical question concerns the consequences of this limited property interest for the company and its secured lenders.

D. *Can Soft Variables Serve as Collateral?*

In general, UCC Article 9 and state law permit a company to grant a security interest in most forms of personal property.[72] The core requirements underlying this grant are attachment and enforceability.[73] "A security interest attaches to collateral when it becomes enforceable against the debtor with respect to the collateral, unless an agreement expressly postpones the time of attachment."[74] A security interest in turn generally becomes enforceable upon: (1) the execution of a security agreement between the company and the lender identifying the property

68. *See* WMX Tech., Inc. v. Miller, 197 F.3d 367, 374–76 (9th Cir. 1999) (distinguishing goodwill from reputation and holding that alleged damage to a company's business reputation (and business goodwill) as a result of a government report did rise to the level of a constitutionally protected property interest); First Hartford Corp. Pension Plan & Trust v. United States, 194 F.3d 1279, 1283–84, 1296 (Fed. Cir. 1999) (describing goodwill in the context of bank liquidation and determining that recognition of goodwill could result in a cognizable property interest in a potential liquidation surplus); Robinson v. Watts Detective Agency, Inc., 685 F.2d 729, 741 (1st Cir. 1982) (holding that the prebankruptcy transfer of debtor's employees, customers, and goodwill was a transfer of "property" within the meaning of the fraudulent conveyance law); Glosband v. Watts Detective Agency, Inc., 21 B.R. 963, 975–76 (Bankr. D. Mass. 1981) (same).

69. *See supra* note 66 and accompanying text; *see also infra* note 126 and accompanying text.

70. *See, e.g.*, Irene Calboli, *Trademark Assignment "With Goodwill": A Concept Whose Time Has Gone*, 57 FLA. L. REV. 771, 788–795 (2005) (discussing judicial treatment of goodwill in context of trademark and permissibility in certain cases of transferring only goodwill associated with the mark); *see also Sourcing Goodwill Separately from Other Intangibles*, INTOUCH (CBIZ MHM Nat'l Tax Office, Cleveland, Ohio), Dec. 2012, at 2, *available at* http://www.cbiz.com/page.asp?pid=10120 (explaining, in tax context, "with the issuance of CCA 200911006, the IRS concluded that intangibles such as trademarks, trade names and customer based intangibles that can be separately described and valued apart from goodwill qualify as like-kind property for purposes of the tax free exchange rules").

71. *See* Fragoso, *supra* note 51, at 1711–17.

72. *See* U.C.C. § 9-203(a) (2014).

73. *See id.*; *id.* § 9-203(b).

74. *Id.* § 9-203(a).

as collateral; (2) the exchange of value; and (3) the company having sufficient rights in the property to facilitate attachment.[75] In addition, for the security agreement to be enforceable against third parties, the lender must perfect its security interest.[76] For most forms of collateral, perfection is accomplished by filing a UCC-1 financing statement in the company's state of incorporation.[77]

Because soft variables are not a company's personal property, those variables cannot serve as collateral. As such, any value attributed to soft variables should be distinguished from goodwill associated with tangible and identifiable intangible assets in which the company has a current property interest. The law recognizes the latter as goodwill that may constitute a general intangible eligible to serve as collateral under UCC Article 9.[78] The various components of soft variables (people, synergy, relationships) are fluid: those variables may fail to materialize if, for example, an employee leaves or a legislator changes the law.[79] The company has no certainty in or, in most cases, legal right to soft variables.[80]

The inability to characterize soft variables as a company's personal property does not, however, completely extinguish their value to a company. The company may claim an interest in any value generated by those variables.[81] This property interest should come into existence if and when the value is recognized, either in the purchase price or on the balance sheet of the company or its successor.[82] At that point, an asset emerges that is separate and identifiable and in which the company may claim a property interest.[83] Moreover, such value recognition is not nec-

75. *Id.* § 9-203(b).

76. *Id.*

77. *Id.* § 9-310.

78. *Id.* § 9-106, cmt. 1 ("The term 'general intangibles' brings under this Article miscellaneous types of contractual rights and other personal property which are used or may become customarily used as commercial security. Examples are goodwill, literary rights and rights to performance.").

79. *See* Cipran et al., *supra* note 40; *see also* Appendix C.

80. *See supra* note 55 and accompanying text; *see infra* note 83 and accompanying text.

81. Value generated by soft variables will be recognized either in the form of cash compensation at the time of sale or as an increase in assets on a company's balance sheet at the time of a business combination or reorganization. Note, *supra* note 67, at 687 (noting that goodwill in particular *may not* appear on the balance sheet unless it is "acquired for cash or its equivalent in the purchase of another business, or when a valuation is required as part of a reorganization of the business structure"). That value creates a new asset in which the company has a personal property interest.

82. *See id.* at 688; *see also* RHEE, *supra* note 63, at 33 (explaining traditional recognition of goodwill as an intangible on company's balance sheet in case of acquisition). In addition, markets may recognize the value of a company's soft variables prior to a more definitive triggering event. That value may be inherent in the company's stock price and market valuation. Without a definitive triggering event that monetizes that value, however, it is hard to identify and separate an interest that may constitute personal property for purposes of Article 9.

83. A company may try to assert a contingent, future interest in any value relating to soft variables immediately upon the hiring of any given employee. The company could argue that at least an agreement in principle exists at that point and is sufficient to support a contractual right under state law. This position may be further supported in the case of an actual employment contract. As discussed *infra* Part IV.C., policy considerations cut against these arguments. Although UCC Article 9 permits a company to grant a security interest in certain contingent and even otherwise nonassignable rights, I believe that any such extension of these principles to the employment relationships and other soft variables described in this Article exceeds the intended purpose of the 2001 revisions to Article 9

essarily a one-time occurrence. A company may sell or acquire a division or product line that generates value and supports an adjustment to the company's balance sheet; a company may restructure or reorganize in a manner that generates value above book value or that is otherwise available under a state law foreclosure sale or liquidation.

The following conclusions flow from this analysis: A security agreement granting a lender a security interest in soft variables does not encumber those variables because they do not constitute the company's personal property. A security agreement granting a lender a security interest in goodwill may give the lender an interest in value derived from tangible and identifiable intangible assets that qualify as collateral under UCC Article 9, but not in soft variables. A security agreement granting a lender a security interest in the company's cash or general intangibles likely gives the lender an interest in any value generated by soft variables, but that interest does not attach until the value is recognized.

Dissecting the characterization and role of soft variables in secured lending arrangements is only the beginning of the analysis. One of the most difficult questions concerns how to measure any value generated by soft variables. Moreover, the ability of companies and lenders to contract around and create securitization structures to avoid the company's limited interest in soft variables must be considered in light of the public policy and Constitutional issues raised by soft variables. These issues are addressed below.[84]

IV. THE ROLE OF SOFT VARIABLES IN RESTRUCTURINGS

Soft variables represent internally generated value that often goes unrecognized or is undervalued as just one component of a company's goodwill. Understanding the nature of soft variables, their value independent of a company's tangible and identifiable intangible assets, and the extent of parties' interests in them, underscores their importance to the company. They are essential to the going concern value of a company.[85] But how do we parse out the value of soft variables, and is that economic or public policy value great enough to matter? This Part considers the potential impact of soft variables on business restructurings.

and is not warranted. *See* U.C.C. § 9-408; *see also generally* Thomas E. Plank, *The Limited Security Interest in Non-Assignable Collateral Under Revised Article 9*, 9 AM. BANKR. INST. L. REV. 323 (2001). Notably, even if such an extension was expressly adopted through further revisions to Article 9, it would only affect employment and other relationships in place prior to the filing of any bankruptcy petition. New, postpetition employees and relationships, as well as synergies created by the Code itself, would remain unencumbered property of the debtor and the estate under section 552(a) of the Code. *See* 11 U.S.C. § 552(a) (2012); *infra* Part IV.C.

84. *See infra* Part IV.C.

85. *See supra* Parts III.A. & III.C.; *see also supra* note 54.

A. *The Treatment of Soft Variables Under the Code*

A company's soft variables hold potential value both in and outside of bankruptcy. Yet, soft variables are not directly addressed under the Code and are rarely mentioned in the context of Chapter 11 valuation and allocation issues. The primary exception is section 552 of the Code, which establishes the extent and continuation of a creditor's prepetition security interests in the debtor's property.[86] In addition, several commentators have offered very thoughtful proposals for recognizing unencumbered value for a bankruptcy estate, without necessarily linking that value to a debtor's soft variables.[87] In many ways, this Article complements that literature and offers support for the underlying premise that various stakeholders may have an interest in a debtor's reorganization value.

1. *Section 552 of the Code*

Under section 552(a), property acquired by the debtor or its estate is not subject to a creditors' prepetition security interest notwithstanding any "after-acquired property" clause in the prepetition security agreement.[88] A similar limitation is imposed under section 552(b), which allows a court to cut off creditors' security interest in the proceeds of, or rents and fees relating to, prepetition collateral if warranted by the equi-

86. Section 552 provides in relevant part:

> (a) Except as provided in subsection (b) of this section, property acquired by the estate or by the debtor after the commencement of the case is not subject to any lien resulting from any security agreement entered into by the debtor before the commencement of the case.
> (b)(1) Except as provided in sections 363, 506(c), 522, 544, 545, 547, and 548 of this title, if the debtor and an entity entered into a security agreement before the commencement of the case and if the security interest created by such security agreement extends to property of the debtor acquired before the commencement of the case and to proceeds, products, offspring, or profits of such property, then such security interest extends to such proceeds, products, offspring, or profits acquired by the estate after the commencement of the case to the extent provided by such security agreement and by applicable nonbankruptcy law, except to any extent that the court, after notice and a hearing and based on the equities of the case, orders otherwise.
> (2) Except as provided in sections 363, 506(c), 522, 544, 545, 547, and 548 of this title, and notwithstanding section 546(b) of this title, if the debtor and an entity entered into a security agreement before the commencement of the case and if the security interest created by such security agreement extends to property of the debtor acquired before the commencement of the case and to amounts paid as rents of such property or the fees, charges, accounts, or other payments for the use or occupancy of rooms and other public facilities in hotels, motels, or other lodging properties, then such security interest extends to such rents and such fees, charges, accounts, or other payments acquired by the estate after the commencement of the case to the extent provided in such security agreement, except to any extent that the court, after notice and a hearing and based on the equities of the case, orders otherwise.

11 U.S.C. § 552.

87. *See, e.g.*, Baird & Bernstein, *supra* note 35; Anthony J. Casey, *The Creditors' Bargain & Option-Preservation Priority in Chapter 11*, 78 U. CHI. L. REV. 759 (2011); *see generally* Jacoby & Janger, *supra* note 27.

88. 11 U.S.C. § 552(a); *see* Residential Capital, LLC v. UMB Bank, N.A. (*In re* Residential Capital, L.L.C.), 501 B.R. 549, 612 (Bankr. S.D.N.Y. 2013) (holding that any goodwill generated postpetition for Chapter 11 debtors' business was not product solely of debtor's use of cash collateral and liens did not attach to this postpetition goodwill as a product or offspring of the cash collateral).

ties of the case.[89] The Code does not define "equities of the case." The legislative history suggests that this subsection allows a court to balance the rights of a secured creditor and the rehabilitative purposes of Chapter 11,[90] but it also cabins the subsection's application to "the situation where the estate expends funds that result in an increase in the value of collateral."[91] The relatively few courts to address the equities of the case exception under section 552(b) generally follow the guidance of the legislative history and require some expenditure of otherwise unencumbered funds for the benefit of the secured creditor.[92]

Although section 552 appears to offer opportunities to create or preserve value for the estate, its impact is curtailed by limited use and the following two common practices. First, often at the request of the debtor or secured creditor, courts may grant secured creditors replacement liens in postpetition collateral as adequate protection of the creditors' prepetition secured position under section 361 of the Code.[93] Second, the debtor frequently waives the protections of section 552(b) in its postpetition financing agreement.[94] Accordingly, section 552 rarely generates unen-

89. 11 U.S.C. § 552(b); Fare East Nat'l Bank v. United States Tr. (*In re* Premier Golf Props., L.P.), 477 B.R. 767, 771–77 (B.A.P. 9th Cir. 2012); *Residential Capital*, 501 B.R. at 572.

90. For example, one portion of the legislative history provides:

> [Subsection 552(a)] is designed, among other things, to prevent windfalls for secured creditors and to give the courts broad discretion to balance the protection of secured creditors, on the one hand, against the strong public policies favoring continuation of jobs, preservation of going concern values and rehabilitation of distressed debtors, generally.

140 CONG. REC. H10,768 (daily ed. October 4, 1994); *see also* United Va. Bank v. Slab Fork Coal Co. (*In re* Slab Fork Coal Co.), 784 F.2d 1188, 1191 (4th Cir. 1986).

91. H.R. REP. NO. 95–595, at 3 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6332–33.

92. *See, e.g.*, All Points Capital Corp. v. Laurel Hill Paper Co. (*In re* Laurel Hill Paper Co.), 393 B.R. 89, 92–93 (Bankr. M.D.N.C. 2008) ("The bankruptcy court has discretion in determining whether the 'equities of the case' exception applies to a particular case. However, the legislative history to section 552 provides some guidance regarding the circumstances under which the exception applies . . . . The cases involving section 552(b)(1) appear to place the most weight on whether the debtor expended unencumbered funds of the estate, at the expense of the unsecured creditors, to enhance the value of the collateral." (citations omitted)).

In the *Residential Capital* case, 501 B.R. 549 (Bankr. S.D.N.Y. 2013), the debtors and the committee proposed a plan of reorganization that treated the junior secured noteholders ("JSNs") as undersecured but would pay the JSNs the full face amount of all principal and prepetition interest. The JSNs, however, rejected the plan contending that they were oversecured and thus entitled to postpetition interest, among other things, based on the going concern value of their collateral. Some of the debtor's assets were sold and the JSNs argued that part of the purchase price, which included goodwill and related general intangibles, should be deemed proceeds of the prepetition JSN Collateral. The judge rejected the JSN argument, holding that Section 552(b) only applies to collateral acquired postpetition that is "directly attributable to prepetition collateral, *without the addition of estate resources*." 501 B.R. at 612 (citation omitted).

93. *See, e.g.*, WILLIAM H. LAWRENCE ET AL., UNDERSTANDING SECURED TRANSACTIONS 380 (2012) (explaining the practice of secured lenders seeking a replacement lien in postpetition accounts and inventory as adequate protection); THOMAS J. SALERNO & JORDAN A. KROOP, BANKRUPTCY LITIGATION AND PRACTICE: A PRACTITIONER'S GUIDE 8–47 (4th ed. 2008) ("One common form of adequate protection is a 'replacement lien' on accounts receivable generated post-petition."). A secured creditor is entitled to adequate protection only against a diminution in the value of its collateral. Accordingly, if the value of the secured creditor's interest in the debtor's property does not decrease in value during the case, adequate protection—whether in the form of a replacement lien or otherwise—is not required.

94. *See, e.g.*, Weinstein, Eisen & Weiss v. Gill (*In re* Cooper Commons LLC), 512 F.3d 533, 535–36 (9th Cir. 2008) (affirming validity of debtor's Section 506(c) waiver); *Residential Capital*, 501 B.R. at

cumbered value to support the debtor's reorganization, which is why some commentators propose alternative mechanisms to achieve a similar objective.

2. *Going Concern Surplus and Optionality in Chapter 11*

Several commentators have thoughtfully explored the concept of going concern surplus in bankruptcy.[95] These commentators generally agree regarding the nature of that surplus—i.e., the differential between the liquidation value and the going concern value of the company.[96] They do not necessarily agree, however, on the allocation of that value among a company's stakeholders.[97]

As a general proposition, a secured creditor is entitled to receive the liquidation value of its collateral upon default.[98] Liquidation value may mean a piecemeal fire sale of the collateral; a commercially reasonable foreclosure sale of the collateral; what a willing buyer would pay for the collateral in the market; or some other formulation.[99] Moreover, the presence of a blanket lien in all of a company's collateral, including goodwill, makes this valuation question more difficult. Nevertheless, many commentators equate the liquidation value in this setting to what the secured creditor may be able to receive for its collateral in a foreclosure sale under state law.[100]

572–73 (discussing the debtor's waiver pursuant to Section 506(c)); *In re* General Growth Properties, Inc., 412 B.R. 122, 127 (Bankr. S.D.N.Y. 2009) ("In light of the Lenders' agreement to subordinate their liens and superpriority claims to the Carve-Out, the Lenders are entitled to a waiver of (i) the provisions of section 506(c) of the Bankruptcy Code and (ii) any 'equities of the case' claims under section 552(b) of the Bankruptcy Code, in each case, in respect of the DIP Documents.").

95. *See* Adler, *supra* note 26; Baird & Rasmussen, *supra* note 26; LoPucki, *The Nature of the Bankrupt Firm*, *supra* note 26; *see also generally* Omer Tene, *Revisiting the Creditors' Bargain: The Entitlement to the Going-Concern Surplus in Corporate Bankruptcy Reorganizations*, 19 BANKR. DEV. J. 287 (2003).

96. Adler, *supra* note 26, at 313; Baird & Rasmussen, *supra* note 26, at 754; LoPucki, *The Nature of the Bankrupt Firm*, *supra* note 26; Tene, *supra* note 95, at 295.

97. *See, e.g.*, Adler, *supra* note 26, at 313–14 ("This regime is devoted in principle to a court-supervised distribution of assets or asset value to claimants in order of contractual priority and ratably among those with equal priority."); *but see* Tene, supra note 95, at 288 ("Any additional value (that is, the going-concern surplus) should not be distributed under bankruptcy law, but rather left for the parties to allocate among themselves through a process of structured negotiations.").

98. *See, e.g.*, Douglas G. Baird & Anthony J. Casey, *No Exit? Withdrawal Rights and the Law of Corporate Reorganizations*, 113 COLUM. L. REV. 1, 17 n.59 (2013); Casey, *supra* note 87, at 764; Jacoby & Janger, *supra* note 27, at 918–19.

99. *See* RHEE, *supra* note 63, at 155–59 (explaining different approaches to valuing a company); *see also* H.R. REP. NO. 95-595 at 356 (discussing valuation under section 506 of the Code, noting that "'[v]alue' does not necessarily contemplate forced sale or liquidation value of the collateral; nor does it always imply full going concern sale value. Courts will have to determine value on a case by case basis, taking into account the facts of each case and the competing interests in the case").

100. *See, e.g.*, David Gray Carlson, *Secured Creditors and the Eely Character of Bankruptcy Valuations*, 41 AM. U. L. REV. 63, 75 (1991) ("Liquidation value is usually taken to imply what the creditor could realize in a forced sale under the rules of U.C.C. article 9, real estate mortgage provisions, or, even worse, under the rules of judicial execution."). As previously discussed, valuation—whether on a liquidation or going-concern basis—is imprecise and often challenging in the distressed context, particularly if the secured creditor has an interest in goodwill.

Once the value of the creditor's allowed secured claim is established, the company's value must be allocated. Under the absolute priority scheme of the Code, the secured creditor would be entitled to receive the full amount of its allowed claim before any junior creditors receive any distributions.[101] The empirical and anecdotal evidence suggests that this results in junior creditors receiving little or no value in Chapter 11 cases.[102] Commentators have proposed using alternative allocation schemes, including relative priority and option preserving priority, to identify value for junior creditors even when the secured creditor has or appears to have a security interest in all of the available value.[103] Another proposal contemplates a holdback from the value realized in any going concern asset sale under section 363 of the Code, with those funds being distributed as unencumbered value unless the secured creditor can satisfy certain requirements.[104] All of these proposals struggle with the same basic issue—valuation is uncertain and often times determined by the timing and proponent of the valuation.

This Article supplements this meaningful body of work by analyzing additional value that may exist, regardless of the definition of "liquidation" value or the applicable priority scheme. Notably, at least some of these commentators infer that secured creditors cannot take a security interest in the entirety of the company, or at least question the desirability of such a result.[105] If a company holds a going concern surplus, this Article suggests that some portion of that value is attributable to soft varia-

101. 11 U.S.C. § 1129(b) (2012); *see also* Casey, *supra* note 87, at 763 n.16 (explaining absolute priority rule); *see also generally* Mark J. Roe & Frederick Tung, *Breaking Bankruptcy Priority: How Rent-Seeking Upends the Creditors' Bargain*, 99 VA. L. REV. 1235 (2013) (exploring rent-seeking and other means of priority jumping among creditors and the potential impact of such practices on the system).

102. *See, e.g.*, Brian L. Betker, *Management's Incentives, Equity's Bargaining Power, and Deviations from Absolute Priority in Chapter 11 Bankruptcy*, 68 J. BUS. 161, 161–183 (1995); Julian R. Franks & Walter N. Torous, *An Empirical Investigation of U.S. Firms in Reorganization*, 44 J. FIN. 747, 755 (1989); Lynn M. LoPucki & William C. Whitford, *Bargaining over Equity's Share in the Bankruptcy Reorganization of Large, Publicly Held Companies*, 139 U. Pa. L. Rev. 125, 141 (1990); Lawrence A. Weiss, *Bankruptcy Resolution: Direct Costs and Violation of Priority of Claims*, 27 J. FIN. ECON. 285, 285–314 (1990); Lawrence A. Weiss & Vedran Capkun, *Bankruptcy Resolution: Priority of Claims with the Secured Creditor in Control* 1, (Am. L. & Econ. Ass'n Annual Meetings, Working Paper No. 34, 2007). *But see* Allan C. Eberhart et al., *Security Pricing and Deviations from the Absolute Priority Rule in Bankruptcy Proceedings*, 45 J. FIN. 1457, 1457 (1990) (noting that the balance of power may be shifting away from the traditional rule that shareholder interests in a bankrupt company receive the "lowest priority").

103. *See* Casey, *supra* note 87, at 765 ("[U]nder the proposed mechanism, when the present value of the firm is less than the face value of the senior debt, the senior creditor—rather than getting the entire firm—gets the greater of (1) the nonbankruptcy liquidation value and (2) the entire firm net of the junior creditor's option value. I call this mechanism 'Option-Preservation Priority.'"); *see also id.* at 765–66 n.25 (discussing various approaches characterized as "relative priority" proposals).

104. *See* Jacoby & Janger, *supra* note 27, at 926 ("[W]hen a sale of substantially all assets takes place under § 363 and outside the purview of the Chapter 11 plan process, the bankruptcy court should require the sale proponent(s) to post a bond or reserve a portion of the sale price to cover any damages suffered by the estate. We call this reserved fund the 'Ice Cube Bond.'").

105. *See, e.g.*, *id.* at 922–23 ("Yet, not all property can be encumbered by a security interest as a legal or practical matter. Whatever the intentions of the parties, the so-called blanket lien is likely to have gaps.").

bles and, if realized postpetition, is not (or should not be) subject to a prepetition security interest. The support for this position under the Code and its potential impact on allocation issues are discussed below.

3. *Recognizing Soft Variables in Bankruptcy*

As explained in Part III.D., a strong argument exists that a creditor cannot take a security interest in a debtor's soft variables—whether during the prepetition or postpetition period—and that any blanket lien or interest in goodwill granted to the creditor extends only to the value generated by soft variables once recognized.[106] A simple application of this principle under section 552 of the Code suggests that neither the debtor's soft variables nor any value generated by those variables postpetition are subject to a creditor's prepetition security agreement. Likewise, section 552(b) is largely inapplicable to soft variables because the variables themselves are not collateral; therefore any value generated by soft variables would not constitute proceeds of collateral.[107] In those instances where the triggering event for attachment of the security interest in the value of soft variables occurs prepetition, section 552(b) would, in theory, extend to any proceeds, but that may raise nothing more than a valuation issue.[108]

Unfortunately, very few things in Chapter 11 are simple, and recognizing soft variables as unencumbered value for a debtor's estate is no exception. For example, excluding soft variables and postpetition value from a secured creditor's prepetition collateral package would not prevent a court from granting a lien in the postpetition value as adequate protection of prepetition security interests.[109] In addition, measuring any prepetition or postpetition value is challenging, and the valuation itself may do little for the debtor's reorganization efforts.[110] Creditors also may

106. *See supra* notes 55, 57, and 64 and accompanying text.

107. Article 9 defines "proceeds" broadly to include "rights arising out of collateral," but it would not apply to soft variables that do not constitute collateral in the first instance. *See* U.C.C. § 9-102(a)(64) (2014); *see also* Warner, *supra* note 22, at 522 n.7. To the extent prepetition collateral existed, a court could use the equities of the case exception as warranted by the particular circumstances. *See supra* Part IV.A.1.

108. *In re* Residential Capital, LLC, 497 B.R. 403, 412–13 (Bankr. S.D.N.Y. 2013) (noting that the value of a creditor's claim must be "determined in light of the purpose of the valuation and of the proposed disposition or use of [the property valued]" and holding that, when the debtor plans to retain and continue using the collateral, it is inappropriate to use a forced sale or liquidation value).

109. See *supra* notes 92 and 93 and accompanying text.

110. *See* Elizabeth Warren, *A Theory of Absolute Priority*, 1991 ANN. SURV. AM. L. 9, 13–14 (1991) ("[N]o problem in bankruptcy is more vexing than the problem of valuation. Volumes have been written on it, literally thousands of cases each year involve disputes about it, and virtually every aspect of the bankruptcy system turns on it.").

In *In re* Exide, the valuation experts for the Creditors' Committee and the Debtor disagreed on the valuation of the company. The unsecured creditors' argued the Debtor's plan undervalued the company and overcompensated the secured creditors at their expense. Though the Debtor's valuation relied on market-based indications of value, the court concluded the unsecured creditors' higher valuation was appropriate, which turned out to be incorrect. Kerry O'Rourke, Comment, *Valuation Uncertainty in Chapter 11 Reorganizations*, 2005 COLUM. BUS. L. REV. 403, 404–406 (2005).

work to structure around this principle with securitization vehicles.[111] Overall, the desirability and utility of recognizing soft variables and their value as unencumbered likely turns on Congress' public policy priorities.

B. The Economic Valuation of Soft Variables

How do we value the time, talents, and efforts of people or the relationships they create? How do we value management's decision to move operations overseas, invoke particular regulatory schemes, or combine or jettison certain operating divisions? As discussed above, a company's balance sheet generally does not have a line item for soft variables, unless recognized in connection with a prior business combination.[112] Moreover, soft variables may not always generate positive value; presumably in inefficient companies, soft variables may be more accurately characterized as liabilities.[113] Nevertheless, a company that is viable and holds greater value as a going concern presumably has some internally generated value attributable to soft variables.

This Article does not offer precise valuation methods for valuing soft variables but acknowledges that, like many valuation issues, the process may be uncertain and more art than science.[114] The valuation of soft variables may start with a traditional valuation of a company's goodwill, often calculated to some extent based on the difference in the book or liquidation value and the market value of the company.[115] The value of the goodwill would then need to be allocated to the various components of goodwill, including the company's soft variables.

111. Lynn M. LoPucki, *The Death of Liability*, 106 YALE L.J. 1, 23–25 (1996) (discussing the increase in special purpose vehicles or "bankruptcy remote vehicles" that "puts ownership of the company's valuable assets in an entity separate from the one at risk for [bankruptcy]"); The Comm. on Bankr. and Corp. Reorg. of The Ass'n of the Bar of the City of New York, *Structured Financing Techniques*, 50 BUS. LAW. 527, 533, 553–66 (1995) (describing the benefits of separating asset risk from entity risk and the structuring of special purpose vehicles).

112. *See supra* Section III.C; *see also* Olufunmilayo B. Arewa, *Measuring and Representing the Knowledge Economy: Accounting for Economic Reality Under the Intangibles Paradigm*, 54 BUFF. L. REV. 1, 28–29 (2006) (noting that intangibles are typically not on a firm's balance sheet); Note, *An Inquiry into the Nature of Goodwill*, *supra* note 67, at 687 (noting that goodwill in particular *may not* appear on the balance sheet unless it is "acquired for cash or its equivalent in the purchase of another business, or when a valuation is required as part of a reorganization of the business structure").

113. Olufunmilayo Arewa provides an example of how investment in intangibles effects the earning statement. Arewa, *supra* note 112, at 21–22. Using that example, it is apparent how soft variables could be a liability in an inefficient company, or more specifically, when an investment in soft variables fails to pay off. *Id.*

114. *See, e.g.*, Robert F. Reilly, *Intangible Asset Valuation Due Diligence*, PRAC. LAW., Oct. 2013, at 51, 52; Carlson, *supra* note 100, at 64 ("Because valuations are not verifiable propositions, it is impossible to say as an objective matter whether valuation standards must adhere to 'liquidation' versus 'going concern' value, or between 'use' or 'exchange' value, or whether valuations should be *ex ante* or *ex post* transaction costs.").

115. *See* Note, *An Inquiry into the Nature of Goodwill*, *supra* note 67, at 677 (discussing the concept of "excess value" in accounting for goodwill); James H. Snelson, *Financial Statements*, AM. BANKR. INST. J., Dec.–Jan. 1994, at 13 (same).

Whether this value would be significant enough to make a difference in the company's reorganization is difficult to predict.[116] Even if the dollar value is not great, however, recognizing soft variables may incentivize a company, its employees, and its counterparties to work collectively towards a value-maximizing rehabilitation. The concept of soft variables would give some of these unsecured constituencies a potential interest in the outcome and perhaps a seat at the negotiating table. Indeed, it may reintroduce dynamic tension into restructuring negotiations, which some commentators suggest can create value and a better allocation scheme.[117] The concept of soft variables may also hold value as a policy statement—one that applies to solvent and insolvent companies alike.

C. The Public Policy and Constitutional Issues Relating to Soft Variables

As a society, we value people and their individual contributions to any endeavor.[118] We recognize an individual's autonomy and her right to be treated as an equal under the law.[119] We prohibit involuntary servitude and the sale of individuals into servitude. Although the Thirteenth Amendment is most notable for outlawing slavery in the United States, it also underlies commercial and employment law doctrine, such as the prohibition on filing involuntary bankruptcy cases against individuals under Chapter 13 of the Code.[120] Moreover, courts have traditionally prohibited the assignment of personal services contracts based in part on

116. Intangible assets may account for a significant portion of a company's assets and likely do have growing importance in the broader economy. Arewa, *supra* note 112, at 6–7, 16 (noting intangibles are an increasingly large portion of the value of firms and noting an estimate suggesting that "at least six to ten percent of United States gross domestic product is spent annually on intangibles").

117. Harvey R. Miller, *The Changing Face of Chapter 11: A Reemergence of the Bankruptcy Judge as Producer, Director, and Sometimes Star of the Reorganization Passion Play*, 69 AM. BANKR. L.J. 431, 449 (1995) (noting the statutory creation of a creditors' committee in bankruptcy "was intended to provide dynamic tension with the debtor that would stimulate the reorganization process through effective and efficient oversight and negotiation"); *see also* Michelle M. Harner & Jamie Marincic, *The Potential Value of Dynamic Tension in Restructuring Negotiations*, AM. BANKR. INST. J., Feb. 2011, at 1 (discussing empirical evidence suggesting that tension in restructuring negotiations may increase value); Michelle M. Harner & Jamie Marincic, *Behind Closed Doors: The Influence of Creditors in Business Reorganizations*, 34 Seattle U. L. Rev. 1155, 1178–79 (2011) (same).

118. *See, e.g.*, Irene M. Ten Cate, *Speech, Truth, and Freedom: An Examination of John Stuart Mill's and Justice Oliver Wendell Holmes's Free Speech Defenses*, 22 YALE J.L. & HUMAN. 35, 53 (2010) (discussing the philosophy that "individuals, by pursuing their own goals . . . are instrumental to the achievement of broader societal ends").

119. *See, e.g.*, Herbert v. Lando, 441 U.S. 153, 183 n.1 (1979) ("[I]n a democracy like our own, . . . the autonomy of each individual is accorded equal and incommensurate respect."); Goodridge v. Dept. of Pub. Health, 798 N.E.2d 941, 949 (Mass. 2003) (discussing the state's constitutional "principles of respect for individual autonomy and equality under law" in the context of gay marriage).

120. 11 U.S.C. § 303(b) (2012); S. REP. NO. 95-989 (1995) ("Involuntary chapter 13 cases are not permitted. . . . To do so would constitute bad policy, because chapter 13 only works when there is a willing debtor that wants to repay his creditors. Short of involuntary servitude, it is difficult to keep a debtor working for his creditors when he does not want to pay them back.").

the notion that individuals should have some control over for whom they are providing services.[121]

Soft variables discussed in this Article arise primarily from people and their time, talents, and efforts. Soft variables may hold potential economic value to a company, but they also implicate certain policy and value determinations in a larger context. Suggesting that a company can freely alienate its people or their personal services contradicts long-standing public policy.[122] It also likely makes bad business policy, demoralizing a company's workforce and potentially decreasing value for all stakeholders, including the secured creditor.

Consequently, we should not breach our respect for a person's autonomy unless strong countervailing considerations exist. Certainly, the law should respect parties' contracts, even in bankruptcy, to the greatest extent possible.[123] The stability of financial markets often depends on certainty in legal and contractual rights.[124] Moreover, the Fifth Amendment of the Constitution provides that no party will be deprived of an interest in property without due process of law.[125] These factors must be balanced in determining the proper treatment of soft variables in bankruptcy.

To the extent soft variables are not property of a company, neither the company nor the creditor has an interest in them, regardless of what the contract may say. The company cannot grant, and the creditor cannot receive, a security interest in something that is not property of the company. Even if the security agreement references soft variables, unidentifiable intangibles, or goodwill, that label will not change the substance or legal characterization of soft variables.[126] As such, the recognition of soft

121. *See In re* Grove Rich Realty Corp., 200 B.R. 502, 507 (Bankr. E.D.N.Y. 1996) (noting that revised Section 365(c)(1) precludes assignment of personal service contracts); *In re* Taylor Mfg., Inc., 6 B.R. 370, 372 n.2 (Bankr. N.D. Ga. 1980) (holding contract for performance of personal services which includes nondelegable duties under nonbankruptcy law not assignable in bankruptcy); *In re* Braniff Airways, Inc., 700 F.2d 935, 943 (5th Cir. 1983) (same).

122. *See* sources cited *supra* notes 57 and 58.

123. "Courts . . . generally enforce contracts absent good reason not to do so." Steven L. Schwarcz, *Collapsing Corporate Structures: Resolving the Tension Between Form and Substance*, 60 BUS. LAW. 109, 120 (2004); *see also* Mark Pettit, Jr., *Freedom, Freedom of Contract, and the 'Rise and Fall*,' 79 B.U. L. REV. 263, 291 (1999) ("A contract may be legal but unenforceable . . . [such contracts generally fall under] two broad categories: (a) limitations intended to protect one or more contracting parties; and (b) limitations intended to protect third parties or general society.").

124. Oliver E. Williamson, *The Theory of the Firm as Governance Structure: From Choice to Contract*, 16 J. ECON. PERSP. 171, 176 (2002) (arguing that certainty of contract is a value-preserving governance structure that increases order, mitigates conflict, and improves market exchange); U.N. COMM'N ON INT'L TRADE, LEGISLATIVE GUIDE ON INSOLVENCY LAW at 120, U.N. Sales No. E.05.V.10 (2005), *available at* http://www.uncitral.org/pdf/english/texts/insolven/05-80722_Ebook.pdf (discussing the difficulties in balancing various policy goals, including general public policy goals, the goals of insolvency, and the predictability in commercial relations).

125. U.S. CONST. amend. V; *see* James Steven Rogers, *The Impairment of Secured Creditors' Rights in Reorganization: A Study of the Relationship Between the Fifth Amendment and the Bankruptcy Clause*, 96 HARV. L. REV. 973 (1983).

126. Correspondingly, the International Accounting Standards Board does not characterize many of these soft variables (such as human capital and customer loyalty) as true intangible assets because the firm typically cannot adequately control the expected future economic benefits arising from such resources. IAS 38, *supra* note 64, at ¶15.

variables as unencumbered value would not change the contractual rights of the parties or deprive either party of an interest in property.

Moreover, even if the treatment of soft variables proposed by this Article was viewed as a change in the law, the parties' contractual and Constitutional rights would not be implicated so long as the change was applied prospectively.[127] This position would, however, require a finding that the law currently permits companies to grant security interests to creditors in the company's people, their relationships, and the like. As discussed in Part III.D., this position breaks down under close scrutiny.[128] The only arguable uncertainty in this position is the historical lumping of all value of the company in excess of its stated asset value into goodwill. Moreover, retroactive application may be warranted given the competing policies at stake, and it may be permissible under various interpretations of the Fifth Amendment.[129] Consequently, the more troubling issue may be not how any perceived change is treated under the law but, rather, how it impacts financial markets.

D. The Markets' Reaction to Soft Variables

The principle that soft variables are not property of a company likely runs counter to the expectations of financial markets and their participants.[130] As discussed *supra* Part II.A., term lenders frequently price and extend credit based upon the value of a company as a going concern.[131] Whether those lenders break down that value to the point of recognizing the different components of any recognizable goodwill is questionable; most lenders probably have not considered the scenario. Regardless, the potential value of soft variables and its exclusion from any collateral

127. *See, e.g.*, E. Enter. v. Apfel, 524 U.S. 498, 500 (1998) (noting that "legislation might be unconstitutional if it imposes severe retroactive liability on a limited class of parties that could not have anticipated the liability, and if the extent of that liability is substantially disproportionate to the parties' experience"); United States v. Sec. Indus. Bank, 459 U.S. 70, 81 (1982) (declining to apply 11 U.S.C. § 522(f) on a retroactive basis, finding that it was not intended to impair preenactment property rights); *see* Charles B. Hochman, *The Supreme Court and the Constitutionality of Retroactive Legislation*, 73 HARV. L. REV. 692, 693–94 (1960) ("[I]t has long been accepted that retroactivity is a ground for holding a statute void only if it contravenes a specific provision of the Constitution. After . . . 1798 . . . the only provisions of the Constitution which were available to condemn retrospective civil statutes were article I, section 10, which provided that 'no State shall . . . pass any . . . Law impairing the Obligation of Contracts, and that clause of the fifth amendment prohibiting the federal government from depriving any person of property without due process of law.").

128. *See supra* Part III.D.

129. *See supra* Part III.B.

130. Shareholders of solvent companies certainly view such value to be part of the company's property and equity values reflect this. The same is true for a creditor with a blanket lien. *See* Douglas G. Baird & Thomas H. Jackson, *Bargaining After the Fall and the Contours of the Absolute Priority Rule*, 55 U. CHI. L. REV. 738, 783 (1988) (arguing that a secured creditor—particularly one with an interest in "all" the personal property of the debtor, resulting from firm-specific human capital/know-how—may bargain for a priority interest in the going-concern surplus generated by that firm-specific human capital). This security interest in the human capital "asset" however, could not be levied upon. *Id*. at 784 & n.97 (citing Chicago Board of Trade v. Johnson, 264 U.S. 1, 15 (1924)).

131. *See supra* Part II.A; *e.g.*, Arewa, *supra* note 112, at 17 (noting that the lack of comprehensive disclosure requirements for intangibles gives companies greater latitude to represent economic reality in several ways including with respect to the public markets).

package (at least until value recognition) introduces a contingency that lenders likely have not priced into their credit packages.

Accordingly, financial markets and participants may try to minimize the impact of any perceived change in the treatment of soft variables. For example, lenders may increase the price of term lending, draft covenants concerning what companies are permitted to do with any value generated by soft variables, or require companies to "recognize" value generation from soft variables on a periodic basis.[132] Lenders also may require the company to transfer its operations to a bankruptcy remote entity in which only the secured creditor has an interest so that no competing claims exist for any unencumbered value.[133] Whether the law condones such value recognition or securitization practices would turn largely on the policy choices of courts and policymakers.

These policy choices are not easy, and striking an appropriate balance is difficult. A policy that distinguishes between soft variables and any value generated by those variables preserves our respect for the nature of human capital, encourages all constituencies to work to rehabilitate the company, and does not necessarily remove the value of soft variables from the company or even the secured creditors.[134] It also best aligns with the dual objectives of the Code: rehabilitating debtors and maximizing value.[135]

V. THE POTENTIAL IMPACT OF SOFT VARIABLE IN RESTRUCTURINGS

As suggested above, identifying soft variables as a potential source of unencumbered value in Chapter 11 cases only begins the analysis. The timing of the value recognition and the value generated by that event will depend on the case and its particular facts. In the case of a liquidating or inefficient company, soft variables will be of little consequence.

In the case of a viable company, the presence of unencumbered soft variables does not necessarily determine the allocation of any related value. All or some of that value may still be available to the secured

132. *See, e.g.*, Lucian Arye Bebchuk & Jesse M. Fried, *The Uneasy Case for the Priority of Secured Claims in Bankruptcy*, 105 YALE L.J. 857, 878–79 (1996) (discussing the broad range of demands a secured creditor may issue to a borrower); BABSON CAPITAL MGMT., SENIOR SECURED LOANS 1–2 (Sept. 2010), *available at* https://www.babsoncapital.com/BabsonCapital/http/bcstaticfiles/Research/file/Senior%20Secured%20Loans%20WP_HTWP5407_Oct10.pdf (noting that senior secured loans are usually protected by covenants or contractual restrictions that set minimum standards for a borrower's financial conduct and performance and which may include covenants that are generally tested quarterly).

133. *See, e.g.*, Lois R. Lupica, *Asset Securitization: The Unsecured Creditor's Perspective*, 76 TEX. L. REV. 595, 623–25 (1998) (noting the secured lender may seek to remove the relevant assets to a bankruptcy-remote entity).

134. *See supra* Part III.D.

135. *See* NLRB v. Bildisco & Bildisco, 465 U.S. 513, 528 (1984) ("The fundamental purpose of reorganization is to prevent a debtor from going into liquidation, with an attendant loss of jobs and possible misuse of economic resources."); *In re* Capital West Investors, 186 B.R. 497, 499 (Bankr. N.D. Cal. 1995) ("The objectives of Chapter 11 are: (1) to permit successful rehabilitation of the debtor, and; (2) to maximize the value of the bankruptcy estate." (internal citations omitted)).

creditor if the related value was recognized prepetition or was allocated to the secured creditor postpetition as adequate protection.[136] The remainder of that value may be distributed according to the priorities established by the Code.[137] It also may be allocated among those parties contributing to the value of soft variables—e.g., employees and counterparties.[138]

Implementing a contributory priority scheme would require changes to the Code. These changes would again raise competing policy considerations, though several of the existing policy choices codified in section 507 of the Code—particularly those focused on administrative claims and employee claims—arguably align with a contributory priority scheme.[139] The more challenging question may be whether all of the parties under a contributory priority scheme share pro rata in the unencumbered value of soft variables or whether policymakers try to devise a hierarchy similar to the structure of section 507.[140] A pro rata scheme would be simpler and easier to implement. It also would accomplish the objective of preserving the value of soft variables for those facilitating its recognition through a sale or reorganization in the Chapter 11 context.

Regardless of the ultimate priority scheme, soft variables play a vital role in the reorganization—whether through a plan or a sale—of viable companies. Ignoring the nature of soft variables, and their potential value to a company, not only does a disservice to those working hardest to save the company, but also arguably steals value from the company and those constituencies. If a company's soft variables do not hold such value, it may indicate that a Chapter 7 liquidation is the more appropriate resolution for the company.[141] But, if the company invokes the Chap-

136. *See supra* notes 81 and 99 and accompanying text. The value of soft variables could be recognized prepetition using accrual principles, though the process could also create opportunity for manipulation of financial data. Arewa, *supra* note 112, at 19–20.

137. *See infra* notes 139 and 140 and accompanying text; 11 U.S.C. § 507(a) (2012) (describing the priority in distribution of unsecured claims in bankruptcy).

138. *See, e.g.*, United States v. Van Vactor, Francis & Martin (*In re* Crouch), 51 B.R. 331, 332 (Bankr. D. Or. 1985) ("The purpose behind the 'equities of the case' rule [is] . . . to enable those who contribute to the production of proceeds during chapter 11 to share jointly with pre-petition creditors secured by proceeds.").

139. For example, the costs of administering the estate and certain limited claims of employees are entitled to priority treatment. *See* 11 U.S.C. § 507(a)(2), (4), (5) (2012). Moreover, in general, contract counterparties generally are entitled to timely payment for services and goods provided to the debtor postpetition and to full payment (or "cure") of their prepetition claims if their contract or lease is assumed, or assumed and assigned, by the debtor. *See* 11 U.S.C. § 365; Daniel Keating, *The Fruits of Labor: Worker Priorities in Bankruptcy*, 35 ARIZ. L. REV. 905, 907 (1993) (noting it is understandable why employees enjoy favored status as creditors of the debtor-employer; such employees may be critical to the reorganization).

140. Under section 507 of the Code, a class of priority claims must be paid in full prior to a junior priority claim class receiving any payment. 11 U.S.C. § 507(a) (establishing the priority of claims). In light of the likely contained value of unencumbered soft variables and one policy consideration being compensating constituencies contributing to the going concern value of the company, a pro rata distribution scheme would be preferable.

141. Chapter 7 of the Code is designed primarily to facilitate a traditional liquidation of an individual's or business entity's assets. If the distressed company lacks going concern surplus, Chapter 7 may be the more efficient resolution option. This presumption underlies the "best interests of creditors" test of Section 1129(a)(7) of the Code, which requires a plan of reorganization to provide object-

ter 11 process and the resolution generates value above liquidation or book value, the court and the parties should identify the relevant soft variables and allocate value accordingly.

VI. CONCLUSION

This Article started with the story of Southwest Airlines as an example of soft variables making a difference. The internally generated value at Southwest Airlines has allowed the company to distinguish itself as an industry leader and makes an interesting case study.[142] The Southwest Airlines story does not, however, highlight the importance of the legal characterization of soft variables for distressed companies. For that, consider the Chapter 11 case of American Airlines.

American Airlines filed a Chapter 11 case in November 2011 with "assets of $24.72 billion and liabilities of $29.55 billion."[143] At that point, American's stock dropped significantly it was delisted from the New York Stock Exchange, and the company was valued at less than $90 million.[144] American was facing huge obstacles in its Chapter 11 case, including operating losses, rising fuel costs, and substantial labor and pension obligations.[145]

Although American originally contemplated a stand-alone reorganization in its bankruptcy, US Airways made merger overtures early in the case. Ultimately, the two companies agreed upon a merger, with American emerging as the surviving company. American also used the Chapter 11 process to renegotiate its union contracts, streamline its operations, and facilitate the merger with US Airways.[146] Approximately two years after filing its case, American emerged from bankruptcy with an estimated market capitalization between $16 and $22 billion, which allowed it to repay all of its creditors in full with interest and make a meaningful distribution to its shareholders.[147]

American does not represent the typical outcome of a Chapter 11 case, but it highlights the value generation potential of a company in

ing creditors value at least equal to what they would receive in a hypothetical Chapter 7 case. *See* 11 U.S.C. § 1129(a)(7); *see also* 11 U.S.C. § 704 (bankruptcy trustee should liquidate assets "as expeditiously as is compatible with the best interests of parties in interest"); 11 U.S.C. § 721 (bankruptcy trustee may "operate the business of the debtor for a limited period, if such operation is in the best interest of the estate and consistent with the orderly liquidation of the estate").

142. *See supra* notes 3–5.

143. Kyle Peterson & Matt Daily, *American Airlines Files for Bankruptcy*, REUTERS (Nov. 29, 2011, 10:20 PM), http://www.reuters.com/article/2011/11/30/us-americanairlines-idUSTRE7AS0T22011 1130. My husband is a partner at Latham & Watkins and was part of the Latham team that represented US Airways in the American Chapter 11 case. Nonetheless, my knowledge of, and all information in this Article regarding the American Chapter 11 case is based on the Chapter 11 docket and the other publicly available sources cited herein.

144. *See* Jack Nicas & Mike Spector, *Shares of Bankrupt American Airlines Go Sky High for Investors*, WALL ST. J., Dec. 3, 2013, http://online.wsj.com/news/articles/SB10001424052702304579940457 9236260563432596.

145. *Id.*

146. *Id.*

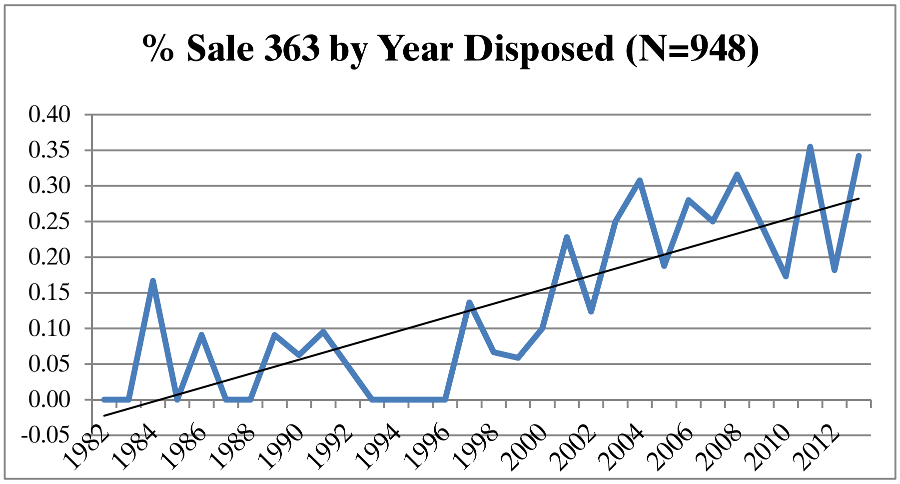
147. *Id.*

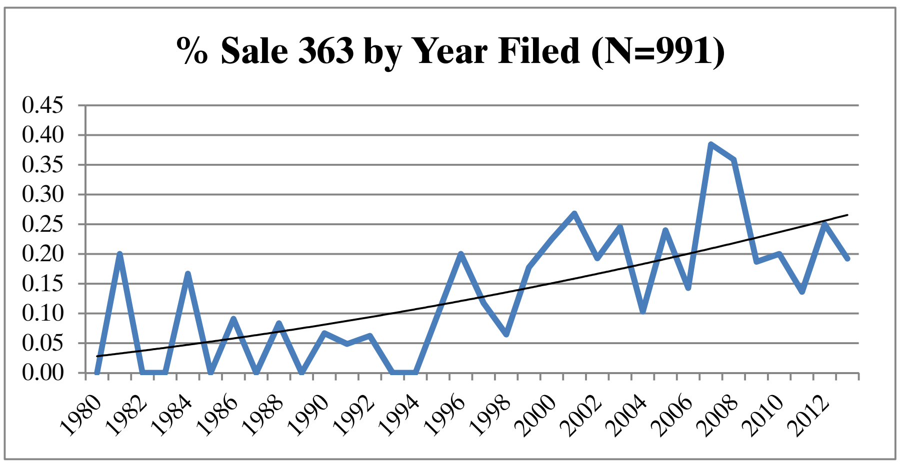
bankruptcy. The value of American's fleet likely did not change significantly in that two-year period; rather, tangible assets of that nature often depreciate in value. But the continued efforts of American's employees; management's decision to invoke, and then their decisions during, Chapter 11; the union's and other contract parties' concessions during the case; the tools available under the Code itself; and the presence of a merger partner who saw potential in the company all created value. If that value had been less than the amount of American's prepetition secured debt, should the secured creditors have been the only parties to benefit?

This Article suggests no: in the context of a going concern sale or reorganization, some portion of the value derives from variables not included in the prepetition collateral package. A company's people, and their ideas, decisions and relationships—soft variables—are not property of the debtor and should not be subject to a secured creditor's security interest unless and until value is generated by those variables. If that value is triggered by an event outside of bankruptcy, that value is personal property to the company and may be subject to an after-acquired property clause. To the extent that value is triggered after the filing of a bankruptcy case, however, that value should be unencumbered subject to the caveats discussed above.[148] Moreover, an allocation scheme that distributes such value to parties contributing to its creation—a contributory priority scheme—likely would align the incentives of the company, the secured creditors, and those responsible for generating value from soft variables to maximize the value of the company. In those cases where a company's soft variables increase the value of the going concern, the people and the process have done their job and should be rewarded accordingly.

148. *See supra* Parts IV.A and IV.C.

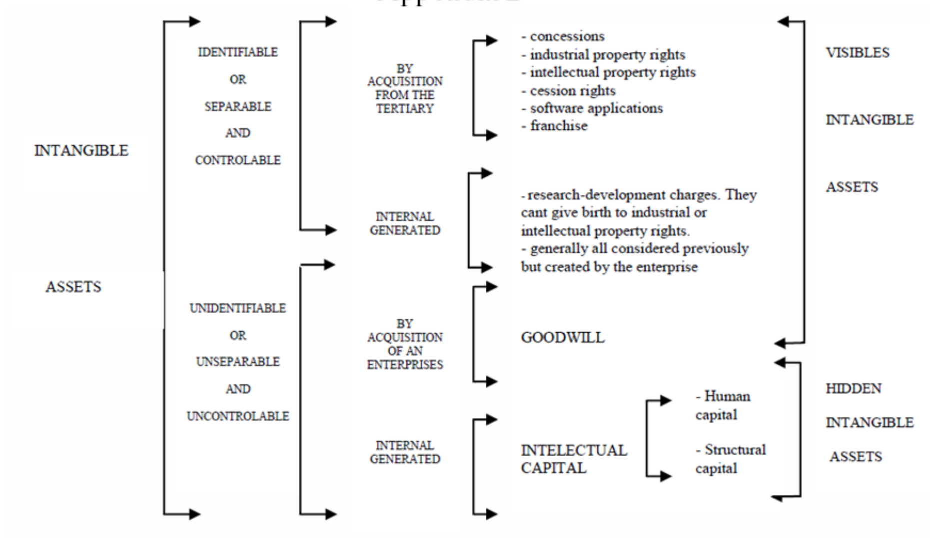
Appendix A





These charts are based on data included in the UCLA-LoPucki Bankruptcy Research Database (the BRD). The BRD includes all bankruptcy cases filed from 1980 to the present, by or against a business debtor or group of affiliated debtors that had assets worth $100 million or more, measured in 1980 dollars. The charts analyze case outcome (*i.e.*, cases ending in a Section 363 sale of substantially all of the company's assets) by year of case filing and year of case disposition. Both charts show a positive linear trend, meaning the percentage of sales has been increasing since the early 1980s. In addition, the chart showing case outcome by year of case filing shows a quadratic trend suggesting that the rate of increase may be slowing.

Appendix B



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